PRELIMINARY REPORT COM. ON REVENUE & TAXATION - CALIF.

PRELIMINARY REPORT

OF THE

COMMISSION ON REVENUE AND TAXATION

OF THE

STATE OF CALIFORNIA

AUGUST, 1906

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PRELIMINARY REPORT

OF THE

COMMISSION ON REVENUE AND TAXATION.

OFFICE OF THE
COMMISSION ON REVENUE AND TAXATION,
2308 Warring Street.

BERKELEY, August 1, 1906.

To the Senate and Assembly:

GENTLEMEN: The Commission constituted in accordance with the act of the 36th session of the Legislature of the State of California, approved March 20, 1905, to investigate the system of revenue and taxation in force in this State and to recommend a plan for the revision and reform thereof, has the honor to submit a preliminary report.

GOVERNOR GEORGE C. PARDEE,
Chairman.

J. B. CURTIN,

M. L. WARD,
State Senators.

H. S. G. McCARTNEY,

E. F. TREADWELL,
Assemblymen.

CARL C. PLEHN,
(Expert on Taxation and Public Finance),
Secretary.

INTRODUCTION.

Why a preliminary report is submitted.

This preliminary report is submitted in response to numerous requests for definite information as to what recommendations the Commission has under consideration.

Criticism invited.

It is hoped that as a result of this early announcement of its plans the Commission may have the benefit of general criticism. Such criticism is hereby invited.

Information desired.

All citizens having definite, authentic information as to the operation of our present system of taxation, or as to the probable effect of the proposed system, or of any part thereof, are respectfully invited to send the same to the secretary. What is wanted primarily is "facts and figures," data that can be adequately verified by the Commission, and which will be of definite use in framing a new system that will remedy the faults in the old. At the same time the commission will be glad to give consideration to any well matured opinions, based upon observation and knowledge, which may not take the form of "facts and figures."

In what sense the conclusions are "tentative."

The conclusions reached by the Commission, thus far, are tentative in the sense that the Commission still stands ready to modify them on presentation of evidence that they ought to be modified. The sole object the Commission has had in view is to ascertain how we may best remedy the glaring evils which are inherent in our antiquated system of taxation. The Commission is not irrevocably wedded to any of its recommendations, even those which are most fundamental. It has reached its conclusions only after diligent investigation, and has full data in hand to support every one of them. But if further investigation or the criticism of this report, above invited, brings additional or modifying facts and circumstances to light, those will be given due weight, whether they support or refute the conclusions herein outlined.

The brevity of this report.

This report is a very brief condensation of the main points which will be set forth at large in the final report. Arguments have been omitted in favor of mere statement of facts, and only the footings or the general averages drawn from the long statistical tables are used.

The final report will be embodied in a volume of some 300 to 400 pages.

The extent of the Commission's work.

The Commission has gathered data from every available source as to the operation of the present tax laws, and has determined, as nearly as may be, the burden imposed on each class of property.

It has carefully examined the financial reports and revenue laws of every State in the Union for suggestions as to remedies, and has corresponded with the tax commissions and other officers and with well-posted individuals in other States.

It has ascertained the taxes now paid and the data necessary to determine what taxes ought to be paid by each class of corporations affected by its plan. It has given a hearing to the different classes of corporations affected, and patiently followed out and verified, or refuted, the arguments presented. At every step it has proceeded without prejudice and without prejudging the results. The correspondence of the Commission in securing information has involved over 4,000 letters.

The Commission has had the constant advice, assistance, and co-operation of the State Controller, the State Board of Equalization, of every Assessor in the State with but one or two exceptions, of Tax Collectors and of city officials. As these officers are in daily contact with the administration of the revenue laws and know their provisions and effects thoroughly, their assistance has been of the utmost importance. They are practically unanimous as to the faults of our present system and the adequacy of the remedies proposed. The State Board of Equalization, especially, gives the Commission's plan its enthusiastic support. The Assessors, in annual convention, have twice endorsed the plan. The State Grange, after a full investigation by an able special committee, also endorsed it.

The Commission has, up to July 3d, held seven meetings of from two to three days each. These meetings were in Sacramento and Berkeley, and some of the members came long distances each time to attend them. Each member has had special assignments of work and has carefully digested and criticised the material collected and sent to them by the secretary. All have familiarized themselves with the legal and economic principles involved.

SECTION I.

ENUMERATION OF CONCLUSIONS AND RECOMMENDATIONS.

The more important findings of the Commission are as follows:

A. Faults in the old system.

1. In general the present system of taxation does not meet the demands made upon it. It is antiquated, having been adopted fifty years ago, and has not been revised to keep pace with modern conditions.

2. It is full of inequalities, which impose a handicap on the growth of the State, a handicap which only the vigor and inexhaustible energy of our people can carry.

These inequalities twist and distort our industries and prohibit a symmetrical development of our resources. They place an undue burden upon agriculture especially; the foundation of our wealth, the one industry which most fully exploits the great natural resources of the State.

3. The taxes paid by farmers in California are equivalent to an income tax of 10%. This is in contrast to many other industries; for example, the taxes paid by manufacturers, which amount only to 2% on income. The persons engaged in agriculture, with an average yearly income of about $500, pay $50 per capita per annum in taxes. The persons engaged in manufactures, with an average annual income of $870, pay $17.50 per capita per annum.

4. Our chief tax, called a *general* property tax, has in fact become a real estate tax. Only from 15% to 18% of the entire taxes are levied on personal property.

5. The amount of personal property on the tax rolls to-day is hardly larger than it was in 1872.

6. Money and credits escape taxation almost entirely. Our laws in regard to the taxation of this class of property are full of absurdities and utterly unenforcible. It is unwise to retain these provisions on the statute books.

7. National banks pay no taxes at all, except on real estate, of which they are not permitted to hold much, by the provisions of the Federal laws.

8. State commercial banks, subject to our tax laws, are badly handicapped by the competition of the untaxed national banks. Many of

them have become national banks partly for the reason that they would not then be subject to taxation.

9. State commercial banks, to live at all, in face of this competition, are forced to evade taxation whenever possible and are hampered in their investments by unwise provisions of our tax laws.

10. Savings banks, which harbor the savings of the workers, and which are, in many States, granted special rebates in taxation on that account, are the only class of banks which pay their full quota of taxes.

11. "Equalization," so called, does not equalize, and in the nature of things, cannot equalize. After the officers have exhausted their best efforts in this direction there are inequalities—glaring ones—between real estate and personal property; between different classes of personal property; between county and county; between city and city; between city and country; between man and man. All of which are rarely removed and often intensified by so-called equalization.

12. The original inequalities in the assessment are intensified by the constant piling up of tax on tax on the same base. If a city has a rate of $1.00, which may be "reasonable" enough, there often comes on top of that a county tax of another $1.00, a few special school taxes, or a sewer tax, or a tax for bonds, or a levee tax, or a drainage tax, etc., etc., until the effects of any inequalities in the original assessment have been multiplied anywhere from two to five fold. Aggregate tax rates falling on city property range from $1.65 per $100 to $5.00 per $100 of assessed valuation.

13. Counties with relatively undeveloped resources often have very high tax rates on relatively high valuations, while some of the richest counties enjoy a low tax rate on low valuations.

14. The present system takes the revenue derivable by taxation from large general organizations, like the railroads, which revenue belongs by right to the people of the State at large, and distribute it most inequitably among the local divisions of the State which have no proper claim to it whatsoever.

15. Under the present system it is impossible to adjust the burden of taxation equitably between different classes of corporations.

16. Our present system is a "school for perjury," puts a penalty on honesty and pays high premiums for dishonesty.

Our present system is so embodied in our Constitution that it can not be bettered without a constitutional amendment.

B. Remedies.

The Commission recommends:

1. Separation of State from local taxation as to sources of revenue.

This is the first step in reform.

Complete separation implies that the State shall collect its revenues

from sources other than a direct levy on real and personal property of individuals, leaving to the counties and cities the exclusive right to tax such property for local purposes.

This will take the burden of direct State taxation off real estate, and save the owners of real estate over $3,000,000 annually.

It establishes, at once, home rule in matters of local taxation.

It abolishes, at once, any necessity for equalization between counties, and cures the evils State equalization fails to reach.

The property belonging to the subjects selected for State taxation shall, so far as it is reached by the State, whether through its earnings or directly, be exempt from local taxation.

Separation, while not a remedy in and of itself, except for the evils arising from the breakdown of so-called equalization, opens the way for a proper classification of the subjects of State taxation, and makes it possible to tax each class with a greater approximation to equality than is possible without it.

The exact boundary line, the line of "separation," between the State's power of taxation and the powers to be exercised by the counties and their subdivisions, will be defined in connection with each class of subjects selected for State taxation.

(See 3 B, "New Sources," below.)

2. That an absolute divorce between State and local taxation be the ultimate aim, and that as nearly complete separation as possible be attained at the very outset.

3. That the State derive its revenues from the following sources:

a. Old sources continued.

(1) The Poll Tax.

(2) The Inheritance Tax.

(3) The Tax on Insurance Premiums.

(4) The annual franchise tax on corporations (modified and made proportional).

(5) All fees now collected.

(6) All collections by State institutions (some of which may be increased).

(7) All earnings of State Property and Investments.

(8) The revenue from sale of State lands.

N. B.—The right to levy on general property should not be surrendered, but should be resorted to only to make good a deficit.

b. New sources.

(1) A gross earnings tax on railroads; street railroads; express companies; car companies; light, heat, and power companies; telegraph and telephone companies, at rates fixed for a period of ten

B. Remedies—*Continued.*

years by constitutional enactment, after which time they may be amended by the Legislature, but not more frequently than once every six years.

This tax is to be in lieu of all other taxes except taxes on property not necessarily used in the operations conducted by the companies, and excepting, also, any so-called "taxes" paid as a consideration for the grant of a franchise. The counties and cities would, therefore, be forbidden to tax this class of corporations.

The rates of the gross earnings tax should be fixed in the first instance by determining what percentage of the gross earnings will normally equal 1% on the full cash value of the corporate holdings.

A simple and logical method for computing this has been devised by the Commission, and the data necessary to determine the rates have been compiled.

1% of the full cash value is deemed a fair rate on real estate and other property on the tax rolls, and the popular demand for "equal" taxation makes it necessary to find a rate on gross earnings which shall be as nearly equal thereto as may be.

(2) A tax on the shares of capital stock of all banks at 1% of the book value of the stock. The book value is the sum of the paid up capital and the accumulated surplus and undivided profits.

This tax, like the gross earnings tax, is to be in lieu of all other taxes on the banks, except taxes on real estate, the assessed value of which is, however, to be deducted from the capital before the 1% rate is applied. Cities and counties would be deprived of the right to tax banks except on their real estate and mortgages.

(3) A tax at the rate of 1% on the assessed value of all corporate franchises of every sort, not covered by the above mentioned taxes, such franchises to be valued by the State Board of Equalization. This tax, also, would be in lieu of local taxes on such franchises, excepting, of course, so-called taxes paid as part of the consideration for granting the franchise.

SECTION II.

THE CONSTITUTIONAL AMENDMENT.

The Constitution prohibits separation expressly, by declaring that, "No county, city, town, or other public or municipal corporation, nor the inhabitants thereof, nor the property therein, shall be released or discharged from its or their proportionate share of taxes to be levied for State purposes, nor shall commutation for such taxes be authorized in any form whatsoever." (Sec. 10, Art. XI.)

Other passages can be interpreted so as to make the same restriction.

The Constitution has, however, a most liberal clause permitting an income tax. "Income taxes may be assessed to and collected from persons, corporations, joint-stock associations, or companies resident or doing business in this State, or any one or more of them, in such cases and amounts, and in such manner, as shall be prescribed by law." (Sec. II, Art. XIII.)

Under this provision it is clear that the State may levy an income tax, not only upon its citizens in general, but upon any class of corporations, or, possibly, even upon any one corporation. This is altogether the broadest provision of the Constitution relating to taxation. It places almost unlimited power in the hands of the Legislature.

It would be perfectly possible to provide a system of State revenues under this grant of power.

The Commission believes, however, that it would not be wise to take advantage of this section.

A *general* income tax is un-American. Our people have so much respect for labor that what is won by honest toil is regarded as sacred and not to be reduced by direct taxation. Sixteen States have tried the income tax. In every case it was a failure, being evaded, disliked, laxly enforced, and yielding small returns. Virginia, the only State which made any success with it at all, and that a small one, has recently, by constitutional convention, adopted the general plan proposed by this Commission.

A *special* income tax on selected classes of corporations, in addition to the taxes now paid, is a possibility under the Constitution, and a possibility which this Commission recommends shall stand. But the Commission does not believe that a resort to such drastic methods at present is either necessary or wise. The necessary reforms can be accomplished in other ways.

The Commission has in preparation a constitutional amendment which will make it possible to accomplish the general results aimed at. The amendment is not presented in full at present for the obvious reason that it may be necessary to modify it later, and it would most certainly lead to misunderstandings if the amendment in the final report differed from that presented in this.

This amendment proposes:

1. The repeal of Section 10 of Article XI. This section, quoted above, prohibits separation.

This section serves no good purpose and never has served one, having been copied from a provision of the Missouri Constitution, which was widely copied in other States. It has no bearing on other provisions of our Constitution.

2. The entire revision of Article 13, which is the chapter or article bearing on revenue and taxation.

The revision is to accomplish the following results:

(1) To eliminate or modify those provisions which might be held to prohibit separation of State from local taxation.

(2) To enumerate the subjects of taxation to be set aside for the exclusive use of the State, and to specify the method of their taxation.

The gist of these changes has been tersely stated above.

(3) To bring all the exemptions now scattered through several sections into one.

N. B.—Sections unchanged will retain their old numbers, to facilitate reference to court decisions and the like where they have been discussed.

SECTION III.

SUMMARY OF THE MORE IMPORTANT STATISTICS AND CONCLUSIONS IN REGARD TO THE OLD SYSTEM.

The following statistics compiled by the Commission will be of assistance as affording a better understanding of the present system:

Present revenues of the State.

The State derives its active or spendable revenues at present from the following sources:

The amounts given are round numbers approximating the average annual yield.

1. The ad valorem tax on property	$6,800,000
2. The poll tax	460,000
3. The inheritance tax	300,000
4. The tax on insurance premiums	200,000
5. The annual franchise tax	300,000
6. Miscellaneous fees	300,000
7. Collections by State boards and institutions	200,000
8. Earnings of State property and investments	940,000
Total revenues	$9,500,000*
Out of the above	$9,500,000
The State pays over to the school districts	4,000,000†
Leaving net State income	$5,500,000

The Commission will, in its final report, make some suggestions as to the minor items in this list. The present report will be confined to the ad valorem tax on property, which is seriously in need of reform.

The school fund.

The $4,000,000 collected by the State for the support of the common schools is only nominally State revenue—it is in reality local revenue. Save for the supervision exercised by the State Superintendent of

*This is exclusive of money collected by the State for the counties, and exclusive of the receipts of the various revolving funds.

†With the addition of the State University, Normal Schools, High Schools, Farmers' Institutes, etc., the State's expenditure for education runs over $5,000,000 per annum.

Public Instruction and the State Board of Education, the control and management of the schools is a matter of local government solely. The State collects, apportions, and disburses the school monies as an agent for the districts. The purpose is merely to bring about uniformity and to let the richer parts of the State help out the poorer.

If it should prove that the available sources of State revenue are insufficient to raise the $6,800,000 now raised by the ad valorem tax, there would be no serious impropriety in leaving part of the State school fund to be raised by the ad valorem tax. In other words, if only partial separation can be had at first, let the remnant of the ad valorem tax be for support of the schools.

The assessment roll.

Full details concerning the assessed valuation of each of the different classes of property are given in the biennial reports of the Controller. The essential facts are displayed in the accompanying chart.

The upper one of the three groups of lines, the one marked "Rates of Increase in Assessment Roll," shows by its angle each year the percentage of increase (or decrease) of that year on the total roll of the year before. The heavy line shows the general trend cleared of the disturbing annual fluctuations. It demonstrates that the total assessed valuation of property is not advancing as rapidly as it used to or as it should. This group of lines, while it may be somewhat novel in form, really presents a better and truer picture of the growth of our assessment roll than the ordinary method. For example, an increase of fifty millions in the tax roll in the fifties, when the whole roll was small, meant a great deal; it may have been an increase of seventy-five or a hundred per cent, while an increase of the same amount in 1904 is quite insignificant, only a little over 3%. The upper line shows these increases in their proper proportions.

The middle set of lines shows the total assessed valuation in the ordinary way. The heavy line shows the trend. These lines present the same facts as the upper line, but do not bring out the rates of increase, merely the absolute amounts.

The bottom line shows the assessment of personal property.

The increase in the tax burden.

In 1860 the amount collected by the State alone from the general property tax was $889,162. It is now, including the railroad taxes collected by the State and turned over to the counties, nearly $8,000,000. The cities and counties add to this nearly three times as much again, or in all something over $32,000,000 per annum. The burden of taxation has increased 9.2 fold, while population has increased only 4.3 fold.

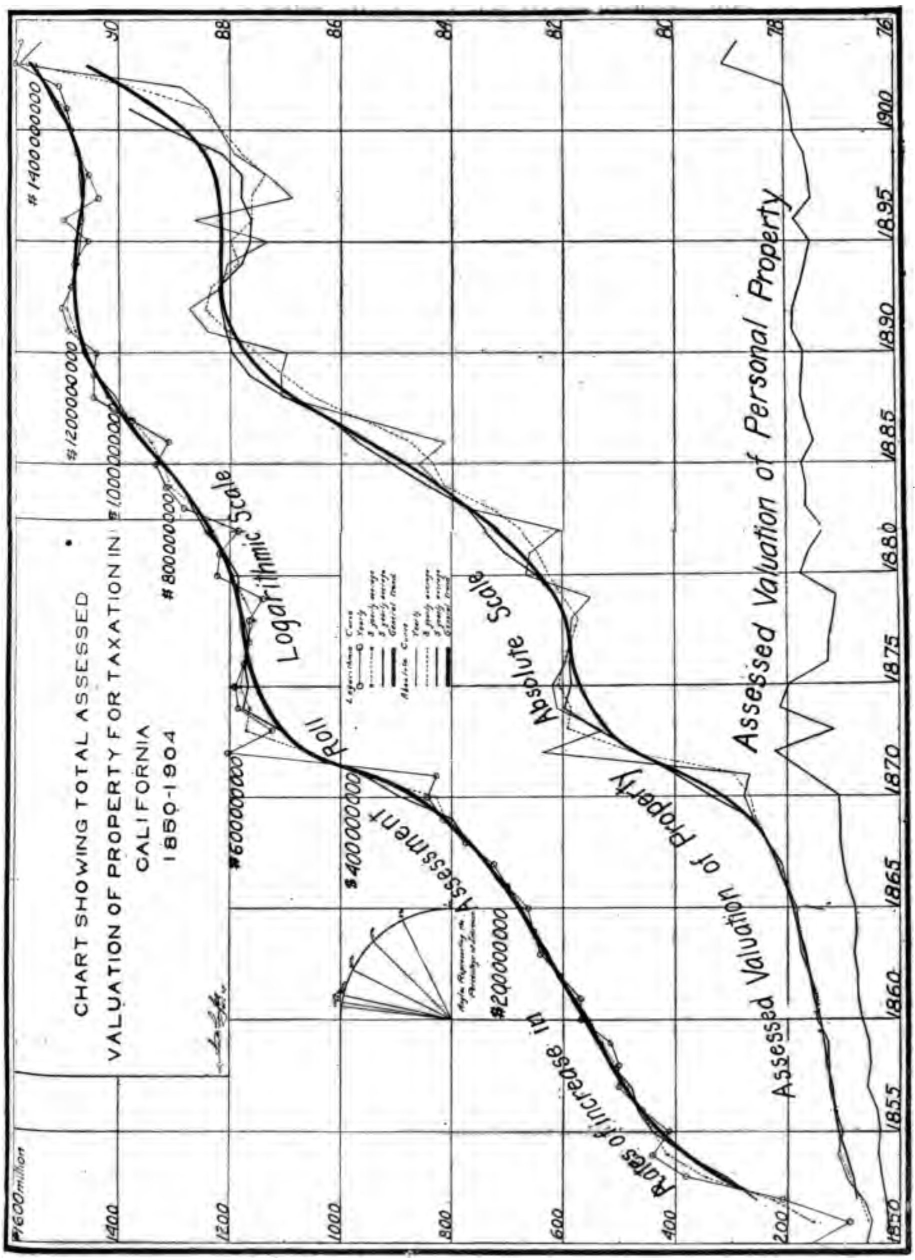
CHART SHOWING TOTAL ASSESSED
VALUATION OF PROPERTY FOR TAXATION IN
CALIFORNIA
1850-1904
Logarithmic Scale
Absolute Scale
Rates of increase in Assessment Roll of Property
Assessed Valuation of Personal Property
Assessed Valuation
$1400000000
$1200000000
$1000000000
$800000000
$600000000
$400000000
$200000000
1850
1855
1860
1865
1870
1875
1880
1885
1890
1895
1900

Personal property is fast disappearing from the rolls.

In 1860 personal property was 46% of the entire roll.
In 1870 personal property was 39% of the entire roll.
In 1880 personal property was 26% of the entire roll.
In 1890 personal property was 15% of the entire roll.
In 1900 personal property was 15% of the entire roll.
In 1905 personal property was 18% of the entire roll.

In 1872 personal property was assessed at $220,000,000. It was not until 1903 that this level was again reached. Meanwhile the aggregate roll increased from $600,000,000 to $1,600,000,000. Practically all the increase of taxation from 1872 to the present has been borne by real estate.

In 1870 the State had a population of 560,000; it now has about 1,625,000. Over a million people have added nothing to the personal property of the State!

In 1880 the assessment of personal property was $201 per capita.
In 1890 the assessment of personal property was $139 per capita.
In 1896 the assessment of personal property was $122 per capita.
At present the assessment of personal property is $150 per capita.
In 1880 the assessment of real estate was $523 per capita.
At present the assessment of real estate is $840 per capita.

Money and solvent credits.

In 1872, under the effect of a new law and the stimulus of the newly created State Board of Equalization, $111,531,623 of money and solvent credits was placed on the rolls, $79,106,590 of which was in San Francisco. These amounts in 1904 were $43,000,000 and $33,000,000 respectively.

That is, after 32 years of boasted growth, and with three times as many people in the State, we have, if it were possible to put any credence in the assessment rolls, only one third as much money on hand and due as at the beginning of the period.

Other items of personal property.

Almost the same thing can be shown concerning other items of personal property. According to the assessors' returns our people have only $13 worth of furniture apiece, for each man, woman, and child—hardly enough to buy a bed and bedding.

Effect of inequalities between localities.

The Commission did not deem it necessary to make an investigation of the extent of the inequalities between different localities, because the plan which they have to propose will, if adopted, destroy their significance. But the following table, showing how these inequalities work and how terribly unjust they are, shows the desperate necessity for "doing something."

Effect of Unequal Valuations on Three Hypothetical Counties.

One assessed at 75%, one at 50%, and one at 66% of full value.

	County A, 75 Per Cent.	County B, 50 Per Cent.	County C, 66 Per Cent.	Totals.
Full value	$40,000,000	$130,000,000	$30,000,000	$200,000,000
Value fixed by Assessor	30,000,000	65,000,000	20,000,000	115,000,000
State tax to be paid at 50 cents	150.000	325,000	100,000	575,000
State tax should have been	115,000	373,750	86,250	575,000
Differences	35,000	48,000	13,750	
	Too much.	Too little.	Too much.	

County B robs A of $35,000 and C of $13,750, a clear gain of $48,750.

In other words, County B shunts off 14% of its fair share of the State taxes on to its neighbors.

The variations in the rates of assessed to true value here assumed are not larger than ordinarily occur, and yet they work a grievous wrong.

Abolish the State tax—or diminish it—and you either abolish or diminish the injustice.

Taxation of farms.

The United States census furnishes the following facts concerning farms in California.

The total value of all farm property was reported as $796,527,955, which was subdivided as follows:

Land and improvements not buildings	$630,444,960	or 79%
Buildings	77,468,000	or 9.7%
Implements	21,311,670	or 2.7%
Live stock	67,303,325	or 8.5%

The total value of all farm products in that year was $131,690,606, which was 16.5% of the value of the farms. The value of all the farm products not fed to live stock was $118,202,036, or 14.8% of the value of the farms. Labor was paid $25,845,120 and fertilizers cost $937,050, a total of $26,872,170, leaving a net product of $91,491,866, which is 11.5% of the value of the farms. This total, however, includes the farmer's own compensation for his own labor and for the labor of the members of his own family. Out of this, also, the farmer must pay taxes, insurance, repairs and other expenses. In short, it includes not only the return on the investment, but also a certain amount of reward of labor other than that actually paid to hired laborers, and considerable expense.

This Commission has ascertained the following facts in regard to the taxation of farms.

The $726,480,653 worth of farm lands and improvements was assessed at $474,731,497, or about 65%, and paid taxes amounting to $8,265,000.

With personal property assessed at $44,000,000 more these total taxes become $9,030,000.

Per cent of taxes to true value	1.14
Per cent of taxes to gross returns	6.86
Per cent of taxes to net returns, including farmer's own compensation and certain expenses	9.88

In other words, the taxes paid by farmers in California are equivalent to an income tax of about 10%. No other industry and no other equally extensive class of property in California bears such a burden of taxation.

In order to show the relative burden of taxation as between agriculture and manufactures, we have prepared the following table, based mainly upon the census returns:

Comparison of Taxes on Farms and Taxes on Manufactures in California.

	Aggregates.		Percentages of Total Capital.	
	Manufactures.	Agriculture.	Manufactures.	Agriculture.
Capital total	$205,395,025	$796,527,955	100.0	100.0
Land	34,735,416	630,444,960	16.9	79.0
Buildings	22,562,385	77,468,000	11.0	9.7
Machinery, resp. implements	62,440,759	21,311,670	30.4	2.7
Other assets	85,656,465	67,303,325	41.7	8.5
Assessed value	63,500,000	474,731,497	31.0	65.0
Taxes	1,049,932	9,030,000	.51	1.14
Gross product	302,874,761	131,690,606	147.0	16.5
Net product	52,172,862	91,419,866*	25.4	11.5
Taxes of gross product			.346	6.86
Taxes of net product			2.01	9.88

The above table constitutes a most telling exhibit of the inequalities of our tax system.

Manufactures pay ½ of 1% on their capital in taxes; farms pay 1.14%, two and a third times as much. Manufactures pay ⅓ of 1% of their gross income in taxes; farms pay nearly 7%, or twenty times as much. Manufacturers pay 2% of their net income, while farmers pay 10%, or five times as much. If we allow manufacturers 10% on their capital as a fair return on the investment, then on the average manufacturers should pay 2.9% on gross earnings to equal which would only be allowing farmers a return of 4¾% on their capital.

The same facts may be exhibited in another way. After allowing $2,446,238 for the average annual increase in the value of farm property and deducting 6% as interest on the value of farm property, the census estimates that the 145,801 persons engaged in agriculture earned an average of $499.70 in 1899. The 113,155 persons engaged in manufactures earned an average of $870.

*Including some items analogous to wages and certain items of expense eliminated in the *case of manufactures.*

It would seem, then, that from the per capita earnings manufacturers could afford to pay nearly 75% more taxes than could the farmers. As a matter of fact, however, the farmers pay 10% of their net earnings and manufacturers only 2% of their net earnings. It may be that the people desire to foster manufactures by a partial exemption from taxation, but it would appear that the exemption granted goes far beyond what is probably intended.

The persons engaged in agriculture pay on the average $50 per capita each year in taxes out of an average income of about $500. The persons engaged in manufactures pay on the average $17.50 per capita each year in taxes out of an average income of $870.

Taxation of city real estate.

The Commission has determined that city real estate pays taxes amounting on the average to 11% of the gross rentals, or approximately 16% of the net income.

This appears to be more than on rural property. But in considering it two important facts must be borne in mind. First, that city real estate yields a net return with less trouble to the owner than farming property; second, that city governments furnish more facilities: streets, lights, sewers, police and fire protection, than do the county governments.

These are, moreover, averages of the most general character, and are open to all the objections against averages in general. The rate is much lower for flats, apartment houses, etc.; higher for business property, and so on.

Some valuable data on this subject, in preparation by several large real estate firms in San Francisco, who kindly volunteered to aid the Commission, were destroyed in the great fire. We preserved only some preliminary estimates.

There is no doubt, however, that city real estate is heavily overtaxed.

This, however, is to some extent offset by the fact that in the cities a larger amount of personalty escapes.

The rates.

The following table sums up the results of a long and tedious investigation of tax rates. It gives the basic figures upon which many of the conclusions and recommendations stand.

The averages for the total rates, namely, $1.75 and $2.10, are as nearly correct as it is possible to make them statistically. They were obtained by ascertaining the total taxes collected in the State, (1) on outside property, (2) on inside property, and dividing this by the total assessed valuation of property. They are not the arithmetical mean of the rates, which is sometimes assumed to represent the average.

nor are they the sums of assumed rates for State, county, road districts or cities.

Average tax rates.

The average total tax rate levied on property outside corporate limits is $1.75 per $100 of assessed valuation.

The average total tax rate levied on property inside corporate limits is $2.10 per $100 of assessed valuation.

The outside rate is made up, approximately, as follows:

For State tax	$0.50	per $100 of assessed valuation.
For county tax	0.85	per $100 of assessed valuation.
For road tax	0.40	per $100 of assessed valuation.
	$1.75	per $100 of assessed valuation.

The inside (city) rate is made up, approximately, as follows:

For State tax	$0.50	per $100 of assessed valuation.
For county tax	0.85	per $100 of assessed valuation.
For city tax	0.75	per $100 of assessed valuation.
	$2.10	per $100 of assessed valuation.

These rates average 1.14% of the full cash value for rural property, and 1.26% of the full cash value of city property on the rolls.

The rates vary from year to year and locality to locality, but the averages for the State vary but a few cents from year to year. The general tendency is for them to increase as the percentage of assessed value to true value decreases.

The range in the total rates in different parts of the State for cities is from $1.55 per $100 to $5.00 per $100 of assessed valuation, "outside" from $1.55 to $3.00 per $100.

Inequalities between different classes of corporations.

The inequalities of our present tax system, as applied to different classes of corporations, will be discussed in detail in connection with the special discussion of the taxation of each class of corporations below.

The following table brings together for comparison some of the more important of the figures.

Taxes Paid by Different Classes of Corporations.

	Taxes to Capital.	Taxes to Gross Earnings.
State commercial banks	.65	------
Savings banks	1.02	------
National banks	.20	------
Railroads	.65	3.64
Street railroads	.605	4.624
Express companies	.14	.514
Telephone	.52	2.073
Telegraph	.33	3.06
Light, heat, and power	.58	3.03
Water companies (excepting Spring Valley)	.66	7.09
Spring Valley	1.26	16.09

SECTION IV.

SEPARATION.

Introduction and definition.

The separation of State from local taxation as to sources of revenue has come to be generally recognized as the one feasible pathway for tax reform.

As this Commission uses the term "separation of sources" it means that the counties and local governments shall tax only the private or individual real estate and tangible property within their boundaries, property, that is, which is clearly and distinctly localized. This class of property has a distinctly local situs and benefits obviously and directly by local government. Upon this class of property there shall ultimately be no State tax. The State, on the other hand, shall tax all those industries, and classes of property sometimes called "corporate" to distinguish them from the "private or individual" industries and properties. Such property does not have, in the same sense, a local situs; it extends over many communities, serves all, and all contribute to its income. Steam and electric railroads, telegraph and telephone companies, express companies, insurance companies, banks, trust and loan companies, light, heat and power companies, and even certain manufacturing and trading companies with branches in different localities, all of these have no distinct local situs, as does a piece of land, or a business block. The characteristic of all such corporate enterprises is that the value of the business which they carry on in any particular municipality is more or less intimately dependent upon the business carried on by them in one or more other municipalities, rural or urban, and can not, therefore, be properly estimated or taxed in any one place, or even in a series of places. Such property and industries are general. They belong to the people of the State as a whole, not to any particular community in which by accident their rails, wires, or offices may be.

The general, non-local, character of corporate property is so obvious that it seems almost superfluous to argue that the taxes thereon do not belong to the localities. But as this idea is comparatively new in practice it may need illustration. A carload of butter and cheese may be shipped from Humboldt county to New Orleans. On its way it will pass through many counties. We should hold it robbery if each county erected toll-gates and collected tolls on that carload of Humboldt

products. But that is practically what we allow when we permit the counties to tax the railroads. Or, again, a vineyardist in Napa may ship a cargo of wine to London; a San Francisco bank buys the bill and "finances" the operation. San Francisco in taxing the banks virtually levies a toll on the Napa vineyardist's goods. Every year the banks bring in large sums of money to "move the crops." This money goes all over the State, even into localities where there are no banks. Every producer in the State contributes to the profit which the banks make on the transaction. Why should this business be taxed in San Francisco, Stockton, Sacramento or Los Angeles only? The business is general, and the taxes on it should be for the support of the State government, which represents all the people and all parts of the State alike. Does the fact that San Bernardino county, Nevada county, and Siskiyou county sit at the gateways through which the railroads enter the State give them a right to tax every yard of cloth, every box of crackers, every plow, and all the other multitudinous wares which the people of this commonwealth bring in?

The right to do business that is enjoyed by corporations is a privilege granted by the State, and not by the cities or counties. Therefore, any tax that may be levied upon the revenues derived from the enjoyment and use of the State privileges used by corporations, especially public service corporations, ought to be paid into the State treasury for the support of the State government, from which the privileges are derived, rather than into city and county treasuries.

Obviously there is a perfectly clear line of demarkation between property local in character which should be subject to local taxation and property or industries general in character which should be subject to general or State taxation.

To accomplish separation it is necessary to define clearly and sharply the boundary line between State and local powers of taxation. This boundary line having been once defined, neither of the two parties shall trespass upon the territory set apart for the other. It implies that there shall be an end to the everlasting piling up of rate on rate on the same subjects or the same foundation, which is the bane of our present system of taxation.

Separation will give the counties substantial home rule in matters concerning their own taxation, and to the same extent there will be home rule in matters concerning city taxation.

Within strictly defined limits the county, or, respectively, the city, should be permitted to determine its own policy concerning the raising of revenue. This does not preclude general laws intended to bring about a certain amount of uniformity as to methods, but it does preclude that constant deference to the effect of State or other sur-taxes which tends to divert the attention of the assessing officers from their primary

duty, which is to establish uniformity and equality of taxation between man and man. It is indisputable that separation would abolish the chief incentive to and cause for undervaluations and remove the chief source of the existence of discriminations.

Separation would at once abolish all the evils which "equalization" is intended to prevent, but which it unfortunately fails to remedy.

The crude assumption that each and every interest should be taxed in the same way in proportion to the property which it uses is one of the fundamental iniquities of our present system. This it is which prevents us from taxing each interest in accordance with its ability to pay.

Theoretical considerations.

The theoretical principle for the separation of State from local taxation is found in part in the natural distribution of functions between State and local governments. The activities of the local governments, such as the protection of property by the police, the fire departments, the local courts, the construction and maintenance of roads, streets, bridges, and the like; the provision for schools, the care of the sick and of the poor, redound distinctly, directly, and peculiarly to the benefit of local real estate owners, or local industries and enhance and sustain the value of real estate and of other tangible property in the localities. This has always been the ground for the making local governmental expenses a local charge. Separation makes no change in this respect, but it does propose to relieve local property from State taxes and from the expenses of general activities, the benefits of which are not directly traceable to the activities of the local government.

In the counties outside of the cities, the chief local industry is agriculture, and it seems peculiarly fitting that the local industries should bear the expenses of its own protection and support the local charges. There is probably no better way of apportioning the taxes among a group of farmers for the support of the charges of the local government than by the taxation of real estate. The property tax originated as a neighborhood tax, and works best when used to apportion neighborhood charges among neighbors. It can be made effective only among a group of persons who know each the other's affairs to a large extent, and where deception and concealment is not easy.

In cities, generally, it is the growth of the city that gives value to real estate. This may be admitted without going the full length of the claims of the single taxers, that it is the activities of the city alone which give value to real estate. From either point of view it seems

proper that such property should bear the greater part of the expenses of the city which creates its value. Strong arguments have been advanced in support of the contention that the local expenses should be *limited* to the amount which the local real estate can afford to pay; whether these arguments are valid or not, they point the conclusion that real estate should pay the local expenses.

On the other hand the activities of the State are all broad and general. This is uniformly recognized in the constitutional provisions now found in almost all State constitutions prohibiting local or special laws. The duties of the State are mainly legislative. It provides a uniform code of laws, the same throughout its entire territory. It provides laws under which business is conducted. It grants charters to industrial and other corporations. It administers such public institutions as are in no sense local in character. In general the State cares for all those interests that are too broad or too large for the local governments to handle.

Corresponding almost precisely to the general activities of the State government, we find the properties and business of the great public service corporations which pervade the whole State, such as the railroads, the telegraph and telephone companies, the express companies, and, of late, the light, heat, and power companies, which have spun their wires like a spider's web over many communities, or the insurance companies and the banks, whose business is in no sense confined to one locality. These industrial corporations are distinctly and peculiarly the creatures of the State, and it is to the State, and not to the counties or the cities, that we naturally turn for their regulation and control. They serve the people of the State as a whole, and are prohibited from bestowing favors on any one community. There is little or nothing localized about them, nor do they benefit, save, possibly, in so far as their local franchises are concerned, in the same peculiar and direct manner as does private individual real estate by the activities of the local government.

There is, thus, ample theoretical ground for making a separation as to the sources of State taxation from those of local taxation. The general classes of corporations which we have had under consideration are so broad in their activities, their stockholders, and, including for the nonce the oft forgotten consumers of their products, or of their services, are so widely scattered that the propriety of taxing them, where, by some accident of organization or of legal enactment, their head office may be or their property may lie, is clearly illogical.

Practical considerations.

The practical reasons for the separation of State from local taxation are:

1. Complete separation will abolish at once the expense, friction, and annoyance of the vain attempt to equalize between the different counties. Partial separation will lessen this evil, because as the proportion of State taxes to the total tax burden on each citizen is reduced the inducement to undervaluation is reduced in like proportion.

A large part of the inequalities in the assessment have their origin in the attempt of assessors to save part of the State burden to the county by undervaluation.

The State assessment roll in California is, as a consequence of the prevailing tendency to undervaluation, practically at a standstill.

From 1850 to 1860 the assessed valuation increased from $57,000,000 to $148,000,000, or at the rate of 16% per annum.

From 1860 to 1870 the increase was at the rate of 8.7% per annum.

In 1872 the codes were adopted and the State Board of Equalization established. Such was the activity of this board and the efficiency of the new law that the assessment increased by 130% in two years, from 1870 to 1872.

From 1872 to 1880 the increase was only at the rate of 1.3% per annum.

From 1880 to 1890 the rate of increase was 6½% per annum.

From 1890 to 1900 only 1.1% per annum.

From 1900 to 1902 the roll increased 3% each year.

In 1903, after great efforts by the State Board of Equalization and slashing increases in many counties, the roll reached nearly $1,600,000,000. It dropped back about $50,000,000 the next year, and this (1905) year has gone to $1,625,000,000, a gain of 1½% in two years, or an average of ¾ of 1% per annum for the two years.

No one will assume that this represents the true increase in the wealth of the State in the past two years.

2. When separation is permitted it is possible to place each tax in the hands of that branch of the government which is best adapted to administer it. The taxation of public service corporations, for example, whose business pervades the whole State, can not be adequately handled by the local assessors. In every case, in order to obtain any sort of equality, uniformity, and justice in the treatment of these great corporations, it is necessary to call in the assistance of a State board, even if the resulting taxes are distributed among the localities. This is one of the several points at which the general property tax breaks down, and in which our present administrative organization in California is especially weak. If we have separation of sources the State alone would

deal with these corporations. This would save a great amount of friction and more or less expense.

The different classes of corporations can not all be successfully taxed by one and the same method. That has been partly recognized in California already in the taxes imposed on the premiums of insurance companies. The local assessors and other administrative officers, engaged, as they necessarily will be, largely in the administration of the local taxes, can not safely or wisely be entrusted with the administration of several other sorts of taxes. Nor have these officers in the past shown any ability to handle the administration of broader matters concerning taxation. What is needed is separate machinery for the administration of each of the different taxes.

3. The different taxing districts could each have practical "home rule" in matters relating to taxation. There would no longer be any object in underassessment if there were no State tax, or but a small one, to be apportioned to the counties on the basis of the assessment made by the county assessor. If for any reasons peculiar to its local conditions, one county preferred to have a high rate of assessment and a low nominal tax rate it could do so without assuming more than its fair share of the State burden. If another county preferred to have a low assessment and a high nominal tax rate it could do so without evading any portion of its obligations to the State. If for any reason a county preferred to have its assessment roll revised once in several years only, it could do so without damage to any other community and with a considerable saving in expense to itself. Other advantages in this connection will suggest themselves.

If each branch of the government collecting taxes did so independently of the action of the others there could be no clashing of adverse interests, and the administration would be much simpler and more economical.

To secure uniformity in the distribution of the burden and equality between different classes when taxes are levied by different authorities is the function of the general revenue law of the State.

Separation in other States.

Many of the Eastern States have introduced the plan for separation of State from local taxation. Pennsylvania was the pioneer in this line, and has had such a system in force for many years. New York has, after 25 years of gradual evolution, attained a similar position. We have selected these two States, together with Connecticut, Ohio, and Minnesota, each with more or less complete separation, to illustrate the way this plan works in other States.

Illustrations of the effects of the separation of State from local taxation in certain States.

New York (1903-1904).

Total State revenue from all sources	$29,297,435.71
Total revenue from direct tax on property (remnant of old tax for canals)	761,085.02
Revenue raised by corporation taxes, licenses, and miscellaneous indirect taxes	$28,536,350.69

This sum of $28,536,350.69 was distributed as follows:

Taxes on insurance premiums	$1,051,774.87
Taxes on transportation earnings	1,007,245.12
Taxes on transportation capital stock	710,903.81
Taxes on telegraph and telephone earnings	132,779.86
Taxes on miscellaneous capital stock	755,088.68
Taxes on gas, water, electric light, etc., earnings	428,083.65
Taxes on foreign banks	62,341.76
License fees	51,290.42
Taxes on trust companies	1,860,876.63
Taxes on savings banks	719,535.37
Total taxes on corporations	$7,033,196.99
Tax on organization of corporations	199,680.16
Inheritance tax	5,428,052.48
Fees from public offices	168,339.61
Liquor licenses, etc	9,147,200.04
Fees from public institutions	39,601.76
Canal fund	3,116,665.12
Miscellaneous receipts	3,403,614.53
Total	$28,536,350.69

The tax rates on corporations for State revenue only are as follows:

On insurance premiums, 1%; on the gross earnings of railroads (the gross earnings resulting only from business originating and terminating within the State), ½%; on the capital, undivided profits and surplus of trust companies, 1%; on undivided profits and surplus of savings banks, 1%; on earnings within the State of foreign banks, 5%; gas, water, and electric light companies pay ½% of gross earnings in addition to 3% of all dividends paid in excess of 4% on paid up capital.

All corporations, excepting banks, title guaranty companies, insurance companies, and some others, pay a tax of ¼ mill for each one percentum of dividends if the dividends amount to 6%, or more, on the capital stock, and lesser rates for smaller dividends. These taxes are *not* in lieu of local property taxes, but *in addition* thereto.

Pennsylvania (1904).

Total State revenue from all sources	$24,067,338.26
State revenue from general property tax	....

Distribution of above revenue—

Tax on corporation stock and bonds	$10,589,732.59
Tax on corporation gross income	1,186,462.32
Tax on bank stock	838,103.43
Tax on insurance premiums	1,293,530.22
Tax on personal property	3,446,906.04
Liquor licenses, etc	1,702,305.83
Bonus on charters	915,892.24
Inheritance tax	1,677,185.48
Mercantile licenses	940,567.86
Miscellaneous (fees, fines, etc.)	3,283,652.25
Total	$24,067,338.26

Pennsylvania levies a general tax upon the total capital stock of all corporations (with certain exceptions) of 5 mills per $1.00 actual value, and 8 mills per $1.00 on the gross receipts of railroads, telegraph and telephone, express, and electric light companies. Banks pay, however, at the rate of 4 mills per $1.00 of capital plus surplus and undivided profits, with the option of paying 10 mills (1%) on the par value of all its shares, and paying the same in lieu of local taxation, except on real estate. Outside insurance companies pay 2% of their total premiums, while local companies pay at the rate of 8 mills upon the $1.00 of their gross premiums and assessments. The State also levies a tax of 4 mills per $1.00 of valuation upon certain classes of intangible personal property, such as mortgages, money owed by solvent debtors, articles of agreement and accounts bearing interest, public land, etc., and vehicles used for hire. Corporations also pay ⅛% on capital stock as a bonus on their charters, which is the price paid for the privilege conferred by the charter.

Connecticut (1904).

Total State receipts, all sources	$3,318,889.19
No general property tax for State revenue.	

Summary of Receipts.

Railroad and corporation taxes	$1,372,089.52
Inheritance taxes	265,780.92
Fees and licenses	10,928.35
Tax on investments	142,005.33
Savings banks	448,383.07
Telegraph and telephone	25,817.14
Insurance companies	313,682.57
Military commutation tax	151,229.00
Insurance Commissioner receipts	122,925.15
Miscellaneous receipts	466,048.14
Total	$3,318,889.19

Connecticut collects a tax of 1% on the capital stock and funded and floating indebtedness of railroads and street railways. This tax is in lieu of all other taxes excepting non-operative real estate, which is taxed locally, and is deducted from the above valuation. Express companies pay 5% of their gross earnings, which is in lieu of all other taxes on their operative property. Telegraph and telephone companies pay 25c on each mile of wire operated within the State. Telephone companies pay in addition 70c on each telephone transmitter. These taxes are in lieu of all other taxes.

Savings banks pay ⅛% of the balance of their deposits, exclusive of surplus over $50,000, and over the amount invested in municipal or State bonds of the commonwealth in the stock of banks, trust or insurance companies. Every male between the ages of 18 and 45 pays an annual tax of $2 in commutation of military duty.

Ohio (1904).

Total State receipts from all sources	$8,427,878.15
Property tax, general duplicate, State revenue	29,251.78
Revenue from other sources	$8,398,626.37

Summary.

Liquor traffic taxes	$1,271,537.16
Excise taxes	1,646,087.78
Corporation fees	914,023.36
Insurance fees and taxes	1,046,211.93
Inheritance taxes (repealed in 1905)	78,208.79
School tax (property tax)	1,973,529.36
Sinking fund receipts	387,354.23
University fund (property tax)	455,300.23
Miscellaneous	626,373.53
Total	$8,398,626.37

Ohio has a system of revenues in which the schools and university are supported by a general property tax, and the general revenue of the State is supplemented to a slight degree by the same method. This general property tax for State purposes is very small, being $93.260 in 1902, and as seen from the above, only $29,251.78 in 1903. All corporations are taxed locally under the general property tax, but railroads, electric light, gas, water works, street railroads, etc., pay in addition ½% of their gross earnings to the State; express companies pay 2% of their gross earnings, less what is paid for transportation of freight.

Insurance companies pay to the State a percentage on gross premiums not under 2½%. Liquor dealers pay $350 per annum.

Minnesota (1904).

Total receipts from all sources		$8,757,323.09
General property tax	$880,292.88	
Property tax, school and university	759,480.13—	1,639,773.01
Revenue from other sources		$7,117,552.08

Summary.

Railroads	$1,974,070.19
Telegraph and telephones	59,350.84
Insurance companies	270,787.37
Express companies	25,864.57
Sleeping cars, freight lines, vessel tonnage	18,016.13
Departmental earnings, fees, etc	1,567,478.37
State institutions	1,181,025.84
Miscellaneous	2,020,958.77
Total	$7,117,552.08

Minnesota has a general property tax yielding $1,639,773 in 1904, a gross earnings tax on public service corporations and an inheritance tax with the usual sources of income from fees, licenses, land, etc.

Railroads pay a gross earnings tax, in lieu of all other taxes on operative property, at the rate of 4% per annum.

Sleeping car companies, freight lines, etc., pay at the rate of 3% on gross earnings; express companies 6%: telephone companies 3%, and insurance companies 2% on the gross premiums received in the State, the latter also paying a property tax.

SECTION V.

STATISTICS ON SEPARATION IN CALIFORNIA.

When the plan of the Commission is finally completed we shall be able to show exactly how the proposed changes will affect each county, and how any changes in the original plan will work.

We have collected complete data concerning the assessments levied on each of the different classes of corporations and the taxes paid thereon in each of the fifty-seven counties in the State. These data were collected from the different assessors, from the corporations themselves, and verified and checked in every possible way.

Some idea of the extent of the data may be gained from the statement that the tabulations alone cover 34 sheets, 15 by 22 inches. As fast as compiled and analyzed the figures for each county were sent back to the assessors for verification. As these reached the assessors during May and June, when they were busy completing their rolls, many of them pleaded for more time to examine and verify them. Hence, all the replies are not yet at hand, and there will probably be some corrections to be made later. Moreover, any changes which may be made in the plan of the Commission on more mature deliberation will alter these figures.

Hence the tables herewith presented are suggestive only. They are not to be considered as final, and will probably be somewhat changed in the final report.

The total direct savings made by the taxpayers in the counties—meaning thereby *only those taxpayers who remain on the county rolls as local taxpayers*—will amount to over $3,000,000. That is, the owners of real estate, who now pay the larger part of the taxes, will be relieved of $3,000,000 taxes annually, which means on the average a saving of at least 21 cents on the present tax rate. These figures are conservative, and the Commission hopes that when finally completed they will show a saving of 26 or 28 cents.

As the overtaxation of real estate is one of the worst faults in our system, the Commission feels particularly gratified that it has been able to devise a plan which affords this class of taxpayers such substantial relief.

How the gain or loss to a county is computed.

Under the plan proposed by the Commission the property of the public service corporations selected for State taxation would not be subject to county, city, and other taxation. The county, therefore, would lose certain revenues, which would have to be made good by increased taxes on the other property remaining on the tax rolls. But that property would in turn be relieved of the old State tax amounting to about 50 cents on the assessed valuation. The difference between these two sums gives the county's gain or loss.

In the following tables we show how much the tax rate in each county will be decreased and what proportion of the total assessed valuation of the county is taken away by giving the State the taxes on the corporate property.

The Gain or Loss in Each County.

	Saving in the County Tax Rate in Cents per $100 of Assessed Valuation.	Percentage of the Assessed Valuation of Public Service Corporations and Banks to the Total Assessed Valuation.
Alameda	21.55	11.85
Alpine	49.00	0.00
Amador	33.17	9.27
Butte	30.44	10.54
Calaveras	38.74	5.76
Colusa	41.70	5.85
Contra Costa	Data incomplete.	
Del Norte	47.66	0.78
El Dorado	16.93	13.86
Fresno	30.52	11.12
Glenn	36.26	7.96
Humboldt	40.94	5.60
Inyo	35.22	7.00
Kern	15.68	22.30
Kings	31.28	10.44
Lake	48.12	1.04
Lassen	41.23	4.44
Los Angeles	29.76	10.62
Madera	7.92	17.64
Marin	34.57	9.60
Mariposa	16.83	13.64
Mendocino	38.21	6.46
Merced	23.66	14.69
Modoc	47.10	1.74
Mono	34.15	7.77
Monterey	27.80	13.25
Napa	35.36	6.91
Nevada	9.84	14.96
Orange	31.41	11.16
Placer	14.88 Loss.	26.93
Plumas	44.68	2.78
Riverside	10.67	19.04
Sacramento	23.58	9.80
San Benito	40.12	5.62

The Gain or Loss in Each County—*Continued.*

	Saving in the County Tax Rate in Cents per $100 of Assessed Valuation.	Percentage of the Assessed Valuation of Public Service Corporations and Banks to the Total Assessed Valuation.
San Bernardino	46.26 Loss.	36.94
San Diego	16.08	14.00
San Francisco	34.60	10.99
San Joaquin	31.80	11.50
San Luis Obispo	31.27	10.64
San Mateo	Data incomplete.	
Santa Barbara	28.00	11.82
Santa Clara	41.54	4.67
Santa Cruz	28.02	8.78
Shasta.	13.94	19.91
Sierra	26.50	7.63
Siskiyou	Data incomplete.	
Solano	38.13	7.54
Sonoma	36.20	9.14
Stanislaus	20.33	13.66
Sutter	36.26	10.14
Tehama	31.71	11.87
Trinity	Data incomplete.	
Tulare	22.41	17.54
Tuolumne	34.62	9.08
Ventura	1.407 Loss.	17.55
Yolo	38.68	9.18
Yuba	17.47 Loss.	18.21

It will be seen that all but four counties make a gain by the change of system. This gain is from 8 cents in Madera county to 49 cents in Alpine, which latter has no public service corporations, and hence saves the entire State tax.

The counties which lose are Placer, Ventura, San Bernardino, and Yuba. The long stretches of railroads in these counties account for their loss. The question of the justice of this loss is discussed elsewhere in this report.

SECTION VI.

TAXATION OF RAILROADS.

(This chapter in the final report takes 150 typewritten pages.)

Taxation of railroads in California. Present system.

Under the existing revenue system of California, railroads are taxed on their property in what is assumed to be substantially the same manner as other property owners are taxed. The only difference is that certain classes of property, not local in character, belonging to railroads are assessed or valued for purposes of taxation by the State Board of Equalization and not by the county assessors.

The State board assesses that part of the property of all railroads operated in more than one county, which is covered by the terms: "the franchise, roadway, roadbed, rails, and rolling stock." All other property belonging to railroads, such as the depots, stations, shops, and other buildings, is assessed by the local or county assessors. Railroad property of the kind specified above is the only class of property in the State which is assessed for purposes of taxation by any authority other than the local assessor. The assessment of each railroad, as made by the State board, is apportioned among the counties, cities, towns, and districts in which that railroad property lies in proportion to the mileage in each. The total assessment of all railroad property under the jurisdiction of the State board was nearly $70,000,000 in 1905.

The taxes levied by the State and by the counties upon the assessment made by the State board are all paid by the railroads directly to the State. The State Controller is held responsible for their collection. After they have been covered into the State treasury, that portion which belongs to the counties is paid over to them by the State. During the two fiscal years 1903--1904 and 1904--1905 the average of the railroad taxes levied on the assessment made by the State for the State and counties was $1,233,439, of which $360,949 was for the State and $872,490 for the counties.

In addition to the State and county taxes on the assessment made by the State board the railroads pay directly to the counties the county taxes levied on that part of their property which is assessed by the county assessors; and directly to the cities and to the counties on behalf of school and other districts, the taxes levied both on the mileage and any other property in such cities and districts.

The following table shows the total taxes of all sorts paid by railroads operated in more than one county in California in 1904.

TAXES PAID BY CALIFORNIA STEAM RAILROADS IN 1904.

(Exclusive of roads operated in one county only.)

Name of Railroad.	Taxes Levied on State Board Assessment.	Taxes Levied on County Assessment.	City Taxes.	Special School Taxes.	Total on Operative Property.	Taxes on Non-operative Property.	Grand Total.
Southern Pacific System	$1,034,846 11	$153,166 75	$87,342 80	$74,069 97	$1,349,425 63	$128,916 18	$1,478,341 81
California and Northwestern	33,151 18	3,203 74	3,587 96	5,427 70	45,370 58	----	45,370 58
North Shore	9,782 72	4,852 19	2,081 75	525 18	17,241 84	226 76	17,468 60
Atchison, Topeka and Santa Fé	241,497 52	33,658 42 (Irrigat'n Dist.	20.225 86 2,894 09)	20,498 34	306,372 32*	12,401 91**	318,774 23
Pacific Coast	4,511 18	1,059 61	588 16	799 80	6,958 75	6,807 93	13,766 68
Pajaro Valley Consolidated	2,646 14	184 12	----	50 64	2,880 90	----	2,880 90
Nevada County Narrow Gauge	2,596 72	597 10	174 45	119 13	3,397 40	----	3,397 40
Nevada, California, Oregon	3,672 88	95 68	----	2 10	3,770 66	----	3,770 66
Sierra Valleys	855 36	40 00	----	----	895 36	----	895 36
Alameda and San Joaquin	2,532 88	650 90	869 10	115 58	4,168 46	----	4,168 46
Guadala Mill	701 54	4,403 13	4 55	30 38	5,139 60	----	5,139 60
Sierra Railway Company of California	8,0 0 58	----	----	343 38	8,423 96	226 36	8,650 32
Boca and Loyalton	4,719 88	103 30	398 25	279 25	5,500 68	----	5,500 68
San Pedro, Los Angeles and Salt Lake	15,830 82	4,243 09	4,785 52	2,377 04	27,236 47	430 00	27,666 47
Lake Tahoe Railway and Transportation Co.	990 36	624 50	82 67	2 80	1,700 33	10 14	1,710 47
Pullman Company	9,534 56	14 99	261 56	717 74	10,528 85	----	10,528 85
Totals	$1,375,950 43	$206,807 52	$123,296 72	$105,359 03	$1,799,011 79	$149,019 28	$1,948,031 07
Per cent of total taxes on operating property	76.00	11.40	6.80	5.8	100.00	----	----
Per cent of all taxes	----	----	----	----	92.4	7.6	100.00

*After deducting $12,401.91 paid on non-operative property and included in foregoing items.

**Included and distributed in foregoing items, except in foregoing total.

It should be observed that although the foregoing table is for 1904, and not for the last fiscal year, 1905, yet the figures are strictly illustrative of the taxation of railroads in this State. The amounts change from year to year, but the proportions are nearly stable.

The table may be summarized as follows: Three fourths of the taxes paid by railroads are levied on the "State Board Assessment," and about one eighth goes to the county on their county assessment, while the cities receive about one eighth.

Table Showing the Assessment by the State Board of Equalization, from the Date of its Establishment, of Railroads Operated in More Than One County.

(Covering the franchise, right of way, road-bed, rails, and the rolling stock.)

1880	$31,174,120
1881	34,829,668
1882	27,602,313
1883	40,017,000
1884	50,746,500
1885	49,035,750
1886	48,051,100
1887	47,677,453
1888	43,242,652
1889	40,488,652
1890	40,198,652
1891	41,414,000
1892	41,956,000
1893	42,478,640
1894	42,730,640
1895	43,018,640
1896	43,223,344
1897	43,491,745
1898	44,457,473
1899	46,394,275
1900	47,711,755
1901	49,121,485
1902	64,812,603
1903	84,187,758*
1904	69,669,566
1905	69,820,186

Taxation of railroads in other States.

Only the more significant features can be given here. The final report will contain a full discussion.

The taxes on railroads in the United States fall into three principal groups: 1. The General Property Tax, 2. Taxes on Capital Stock, 3. Taxes on Earnings.

1. The general property tax on railroads.

In the great majority of the States railroads are still taxed in the same manner as are individuals; that is, on their general property; but in almost all instances special methods have been devised for the

*Included assessment of United Railroads of San Francisco, $20,007,700, afterwards eliminated by order of the courts, leaving the assessment $64,180,058.

application of the general property tax to railroads. The method of assessment is usually different in the case of railroads from that applied to individuals. The most common method of assessment is one similar to ours; namely, assessment of the main part of the system, or, at least, of a considerable part of the property, by some central authority, and apportionment among the taxing districts. The early method of taxing railroad property throughout the country was similar to that which prevailed in California before the adoption of the present Constitution; that is, the assessment was made entirely by the local assessors. This antique method has passed away in all States except Rhode Island. But the changes made have been, in most States, as in California, only such as would make the general property workable when applied to railroads.

The changes are all in one general direction; namely, centralization. Usually all the operative property is assessed by some central or State authority, and is then apportioned among the local divisions. Sometimes, as in Ohio, officers through whose districts a given railroad runs form a board for the assessment of that road. Sometimes the board is an ex officio one, made up of State officials, such as the Governor, Auditor, and Attorney-General. But whatever the method of assessment, there is, in all these States, no essential departure from the principles of the general property tax.

In the assessment of railroads which run through several States, or several assessment districts, it is quite common to apply the so-called "unit rule." The "unit rule" may be applied when the taxes on the earnings as well as when the taxes are *ad valorem*. The term "unit rule," as applied to the taxation of railroads, means the appraisal of the entire system as a unit. The valuation so determined is then divided by the number of miles of main track, or of single track, and the average so obtained multiplied by the number of miles in the State (or district) gives the assessed value for that State (or district). In a similar manner the "unit rule" may be applied to the apportionment of the earnings.

2. Taxes based on capital stock, etc.

The principal tax on railroads in Connecticut, Massachusetts, and in Pennsylvania is one based on the capital as represented by the shares of capital stock, or by the funded indebtedness.

The only one of these systems which could be copied in California is that of Connecticut.

Connecticut.

All operative railroad property in Connecticut is assessed as a unit by the State Board of Equalization. The tax is 1% on the market : of the stock, plus the par value of funded and floating indebted-

ness. The valuation fixed by the board is assumed to be a fair valuation of the railroad, its rights, franchises, and property in the State. When a railroad lies only partly in the State the total capital is valued as above for the entire system. An average value per mile for the entire system is then ascertained, which multiplied by the number of miles in the State is assumed to be the value of the property in the State.

Mr. Clapperton, the expert for the Industrial Commission, reported that this system "appears to be generally regarded in the State as a just system."

As reported by the Interstate Commerce Commission it yields $1,114 per mile, or, with the exception of Massachusetts ($1,426 per mile), the highest tax paid by railroads in any State in the Union.

For comparison we present the following table showing gross and net earnings and taxes paid per mile of road by the principal railroad in Connecticut and the principal railroad in California in 1904:

	Gross Earnings per Mile.	Net Earnings per Mile.	Taxes per Mile.	Per Cent Taxes to G. E.	Per Cent Taxes to N. E.
N. Y., N. H. & H. Inside and outside of Connecticut	$24,140	$6,562	$1,227	4.45	18.8
S. P. System. Inside and outside of California	10,750	3,962	361	3.37	9.1

N. B.—The New York, New Haven and Hartford Railroad operates over 2,000 miles of road, not all of which is in Connecticut. The same is true of the Southern Pacific with reference to California. The comparison suggested in the table should not be taken as a comparison of Connecticut with California strictly; it is illustrative only in the most general sense.

The Connecticut system could be applied in California with some adjustments to meet the local conditions, and would probably be an eminently fair and effective method of railroad taxation.

3. Taxes based on earnings.

The gross receipts tax is the principal tax on railroads in Maine, Maryland, Minnesota, and Vermont. It is used in conjunction with other taxes in New York, Ohio, Pennsylvania, and it has recently been introduced in Virginia as a supplementary tax, and to a very limited extent in Texas. It was the principal tax on railroads in Michigan and Wisconsin for many years, but has recently been abandoned in those States in favor of the *ad valorem* tax on property. It is applied in Illinois to the Illinois Central Railroad Company only. North Carolina and North Dakota each had, some years ago, a gross earnings tax as an alternative to the property tax. But these have fallen into disuse.

The Virginia railroads were formerly taxed on their net earnings, the tax being a part of the general income tax of that State. This has

been abandoned recently in favor of the gross earnings tax. Delaware has a net earnings tax on the statute books, but does not appear to derive any revenues therefrom.

To sum up:

4 States use the gross earnings tax as the chief tax on railroads.
5 States use the gross earnings tax to supplement other taxes.
2 States have recently abandoned the gross earnings tax.
1 State has recently adopted the gross earnings tax.
1 State uses the gross earnings tax for one railroad.
—
13 States use or have used a gross earnings tax on railroads.

The opinion is often expressed in tax commission reports and elsewhere that a tax on the gross earnings of railroads, in so far as those earnings are derived from interstate commerce, is of doubtful validity under provisions of the Federal Constitution.

The constitutionality of a tax on the gross receipts of corporations engaged in interstate commerce.

This Commission made a most exhaustive study of the question of the constitutionality of a gross earnings tax. The abstract of the decisions covers 14 closely-written pages of the final report.

The final conclusion is: It appears, then, that a State tax on the property, or on the franchise, measured by the gross receipts is valid, and is not a "regulation of interstate commerce," in the sense in which the right to regulate commerce is prohibited to the States by the Constitution.

The gross earnings tax as the principal tax.

Maine.

Maine has had a gross earnings tax since 1880.

The tax is designated "an excise tax," and the gross receipts upon which it is levied are defined as the average receipts per mile of the entire system multiplied by the number of miles in the State. The tax thereon is in lieu of all other taxes, except local taxes on buildings.

The rates are:

On gross receipts less than $1,500, per mile ½%.
On gross receipts from $1,500 to $2,000, per mile ¾%.
For each additional $500, or part thereof, ¼% additional up to 4%.

Maine received $418,868 from this tax in 1904, or about $210 per mile of road. The local taxes are small, bringing the total up to $219 per mile. The California taxes are $317 per mile. The low taxes per mile are due to the low rates and to the low earnings of the smaller roads. The Maine Central pays about $340 per mile, having gross earnings of about $8,500 per mile.

Maryland.

Railroads are taxed on their gross earnings for State purposes and on their property for local purposes. The taxable gross earnings are defined as in Maine, as the average earnings per mile for the entire system multiplied by the number of miles in the State.

The rates are:

8-10 of 1% on the first $1,000 per mile.
1½% on $1,000 and $2,000 per mile, and
2% on all earnings over $2,000 per mile.

This complicated method of stating the rates obscures the real effect of the tax. The average of taxes paid to gross earnings is 1.4%. But the average is reduced by the fact that the Baltimore and Ohio enjoys a lower rate; namely, ½%, by legislative contract, made in 1872.

The tax yields about $205 per mile. The local taxes on real estate, roadbed, etc., amount to about $180 per mile more, making a total of $384 per mile.

Minnesota.

In Minnesota the tax on gross earnings has been in use thirty years, and is generally regarded as satisfactory. It is in lieu of all other taxes on operative property and is a State tax. The definition of taxable gross earnings is peculiar, as it applies the unit rule only to strictly interstate business "passing through, into, or out of the State."

The two most important sections of the Act are:

"Section 1. Every railroad company owning or operating any line of railway situated within, or partly within, this State, shall, during the year 1905, and annually thereafter, pay into the treasury of this State, in lieu of all taxes and assessments on all property within this State, owned or operated for railway purposes by such company, including equipment, appurtenances, appendages, and franchises thereof, a sum of money equal to four per cent of the gross earnings derived from the operation of such line of railway within this State; and the annual payment of such sum shall be in full and lieu of all other taxes and assessments upon the property and franchises so taxed. The lands acquired by public grant shall be, and remain, exempt from taxation until sold or contracted to be sold, or conveyed, as provided in the respective acts whereby such grants were made or recognized."

"Section 2. The term 'gross earnings derived from the operation of such line of railway within this State,' as used in Section 1 of this Act, is hereby declared, and shall be construed, to mean, all earnings on business beginning and ending within the State, and a proportion, based upon the proportion of the mileage within the State to the entire mileage over which such business is done, of earnings on all interstate business passing through, into, or out of the State."

The rate was made 4% in 1904. Before that it was 1% for the first three years of operation, 2% during the next seven years, and after ten years 3% per annum. The new rate, and the increase of railroad earnings has increased the revenue to over $3,000,000. The Auditor of State reports that all this has been collected. The yield is nearly $400 per mile.

The State Auditor, the Honorable S. G. Iverson, gave the Ontario Commission the following enthusiastic endorsement of the gross earnings tax, and has been equally strong in his expressions of approval in letters to this Commission:

"We believe in this State that the gross earnings system is a very satisfactory method of taxing the railways. Our people are especially well satisfied with the system of taxation on gross earnings, because they think it is the fairest way, all things considered. Under the *ad valorem* system, a railway runs through a certain county, it touches four townships in that county, there may be twenty townships, outside the four, which are contributing to the business of that road, perhaps even more than the four, but for local purposes those twenty townships outside would not be represented in the assessment of that property, and would get no revenue from it. There are counties in this State which have not a foot of railroad, but they are contributing just the same to the business of the road. Then, if the road is assessed under the *ad valorem* system, there is an eternal turmoil, the township assessors get a crack at it, the county board has to be right, and it is the business of the railway company to see that they are friendly. Then it comes to the State board, and, of course, the railway companies will try to elect the man who will treat them most leniently. This all makes trouble for the public and for the railroads. Now under the gross earnings system we collected two million dollars last year with little expense or trouble, either to the State or the railroads. And every dollar of taxable property in this State is benefited to that extent, whether a county or a township has a railroad or not, the amount paid into the treasury relieves all the properties of the State. We have here a large through business, because of our peculiar situation; we have great lines like the Sault line running up into new country, the Northern Pacific, the Northwestern, the Milwaukee, running through the State, and we get a great amount of business. The gross earnings system is firmly imbedded in our State and in the minds of the people, and until the people become convinced that they are getting the worst of it they don't wish to change from the present condition of affairs."*

It should be noted that Minnesota's method of defining taxable gross receipts gives that State a larger revenue than would be obtained if the strict unit rule were applied. It gets the tax on all traffic within the State, a part of which, under the Maine plan, would be credited to outside mileage, and gets the tax on its full share of interstate traffic.

Vermont.

In Vermont railroads pay, at their option, a tax of 7-10 of 1% on their property in the State appraised by the unit rule on a train mileage basis; or a tax of 2½% on their gross earnings, similarly appraised by the unite rule. These taxes are administered by the State Tax Commissioner. Only non-operative property is subject to local taxation.

Most of the railroads in Vermont elect to pay on their gross earnings, the State collecting, in 1904, $156,133 from that tax and only $8,766 from the tax on appraisal of property.

The gross earnings tax as a supplementary tax.

The gross earnings tax is used as a supplementary tax in New York, Ohio, and Pennsylvania.

These will be described in full in the final report.

*Report of Ontario Commission on Railway Taxation, 1905, pp. 103--104.

The repeal of the gross earnings tax in Michigan and Wisconsin.

Both Michigan and Wisconsin have recently abandoned the gross earnings tax on railroads and reverted to an *ad valorem* tax. The reasons for this seem to have been a vague feeling that the railroads were not taxed as heavily as other property. In response to the same feeling Minnesota raised her rate from 3% to 4%.

The Commission has delved deeply into the voluminous reports presented in these two States at the time of the change of system. A full abstract thereof will be embodied in the final report. But the Commission is not favorably impressed with the arguments presented for the change, and see in the new *ad valorem* tax in these States no improvement over our own system.

The entire operation of the *ad valorem* tax in both these States depends upon a State Tax Commission, which values the property of the railroads. Elaborate provision has been made in each case to secure a strong commission, and in Wisconsin, particularly, the commission is elaborately guarded from sudden change by political whim or railroad influence.

It is felt by this Commission that, however good the results of the reversion to the *ad valorem* tax may be in these States for the first few years, the universal tendency everywhere observed for the *ad valorem* tax to fall behind in revenue yielding power will eventually be observable in these States.

The Commission is of the opinion that our twenty-seven years of experience with the *ad valorem* system in California furnishes a better criterion as to how it will work in the long run than does the three or four years' experience of the two States named.

Summary of the results of the Commission's study of railroad taxation in other States.

If we assume that there should be separation of State from local taxation, and that railroads should be taxed exclusively for State purposes, there seem to be three distinct methods which have been tried in other States. These are:

1. A tax based on capitalization, of which the Connecticut tax is the best example.

2. A tax based on an appraisal of property, of which Michigan and Wisconsin furnish examples.

3. A tax based on gross earnings, of which there are two distinct types:

(*a*) Like that of Maine, where all gross earnings of a given road or system, both in and out of the State, are apportioned; the State taxing its proportion of the whole.

(*b*) Like that of Minnesota, where only the gross earnings of interstate traffic are apportioned; the State taxing all intra-state earnings and its proportion of inter-state earnings.

1. The Connecticut plan. Tax based on stock and bond.

Of these three the first, that of Connecticut, has much to commend it. It yields a large revenue. It is easy to administer. It imposes no unbearable load on the companies. It is as just and equitable as any part of our tax system.

The amount of the tax is determined very nearly by a mathematical rule, which leaves comparatively little discretionary power in the hands of the administrative officers. The data upon which it rests are matters of common knowledge or of public record, and the reports required can not easily be falsified. The results obtained can be checked up by any citizen who cares to criticise the levy, and the correctness or error thereof is easily proven. The officers in charge of its collection are under no temptation to violate their duty, can protect themselves from false charges, and their work can be checked by the regular auditor with little trouble or expense.

The tax can be known in advance by the company with a fair degree of accuracy, and provided for. It will fluctuate in the main with the property of the company and the value of its holdings.

Its constitutionality has never been questioned. It is as nearly as may be an accurate and scientific method of taxing the property of railroads at its market value. It has the endorsement of a strong *obiter dictum* of the Supreme Court. (See State Railroad Cases, 92 U. S. 575.)

The strongest of the objections sometimes brought against it is that the market value of the shares of stock—and in extreme cases of the bonds—of railroads is subject to manipulation, or, what is even more important, may fluctuate for various reasons not strictly related to the value of the property they stand for and represent. The force of this objection is most clearly seen in the case of a railroad whose securities are subject to heavy speculation. What is wanted for the purposes of taxation is that value which most truly represents the earning power of the stock.

But the proper answer to this objection is to so frame the revenue law that the assessing officials shall be guided by the average price of the stock for a considerable period of time—at least one year—and not be bound by its price on a given day. There would be no danger and nothing unreasonable in allowing them to ignore entirely such violent fluctuations as marked, for example, the Northern Pacific stock in 1901. The difficulty has been greatly exaggerated, and is one which can be readily met and overcome by the application of common sense methods used in assessing other classes of property. It is an advantage, rather than a disadvantage, that, in the case of railroads, there are frequent stock quotations available.

The Commission made a careful estimate of the value of the Southern Pacific property on the Connecticut plan, and found it to be in June,

1904, $200,000,000. The same method applied to the Santa Fe gave $67,000,000.

Taxation based on earnings.

While the earnings tax as the principal tax on railroads is openly used in four States only, it is actually the basis of the system in others. Thus in Indiana, whose law regarding the taxation of railroads provides the old-fashioned property tax, the practice of assessment is one based on earnings. The State board in that State bases its assessment of the property on gross earnings, making an arbitrary deduction therefrom for operating expenses and capitalizing the net amount thus obtained to arrive at the value of the property. Their ordinary rule is to take 70% of the gross earnings as operating expenses and capitalize the remaining 30%. The same thing is done more or less systematically in other States; that is, the value of the property is determined by the earnings.

While there have been notable arguments put forward in favor of a net earnings tax, we have found no such tax in operation in this country. Objections to such a tax, both theoretical and practical, will be presented in the final report.

The advantages of a gross earnings tax.

The Commission favors a gross earnings tax. As against a net earnings tax it has obvious advantages. Railroads do not always have net earnings. They do have gross earnings, and they do have extensive possessions. So long as individuals are required to pay taxes on their property, irrespective of whether that property yields a profit or not, just so long will the people demand that railroads, with miles of track, rights of way, rolling stock, and valuable franchises, shall pay taxes, irrespective of whether they make a profit or not. Whatever may be the objections to taxation apportioned according to property—and it is admitted that they are many and serious—yet that is the existing American ideal for taxation in cases where it can be made to work at all. And it is the ultimate measure by which any other system will be tested. If we are prepared to admit that a railroad should be exempt from taxation because its accounts show a deficit, we must admit that a farmer should be exempt when his crops fail and his year's work shows a loss. To most American voters this will be a *reductio ad absurdum*. It is not an idea that will have a strong following.

Furthermore, for fiscal reasons the net earnings tax, involving, as it does, the possibility of a complete or partial failure of revenue, can not be seriously considered. The government must continue; property, including railroad property, must be protected. The government's very existence would be jeopardized if its revenues could be cut off, or materially reduced, by the failure of a large corporation to so manage its business as to make a profit.

If earnings are to be used as a basis of taxation, it must be gross earnings.

Railroad officials, as a rule, are strongly in favor of the gross earnings tax. Their chief reasons are its simplicity, the ease of administration, and, above all, the fact that it always enters in the same proportion into their accounts, so that its effect upon their business is always uniform. It is natural for railroad officials to look upon taxes as an expense incident to business done. If a road does more business this year than last, it buys more coal, pays more wages, and, under this plan, would pay more taxes. Entering in this manner into their accounts, it is not a disturbing nor an arbitrary entry requiring explanations, as would be an increase in taxation in face of a decrease in business. Furthermore, the tax varies from year to year in direct proportion to the fund out of which it must be paid. The tax is, therefore, always in proportion to the road's ability to pay.

That the railroads themselves favor this plan is no evidence that it is one adverse to the public interest. Simplicity, ease, and cheapness of administration, and certainty of returns, are advantages to the government as well as to the taxpayer. Steadiness of growth in revenue is another and a great advantage. The revenue derived from a gross earnings tax will grow with the growth of the community, and will in the long run keep pace therewith. In this respect it has a decided advantage over the property tax. The assessment of property tends to become stationary or to advance at a constantly decreasing rate. Only some radical change in the law or in the administration thereof can counteract this tendency.

There is a marked crystallization to be noted in the assessment of property for purposes of taxation. An assessment once made on a given parcel of property is usually regarded as more or less final, and is changed only as additions are made in the way of new property or new construction. This is universally true, except in rapidly growing communities, where attention is constantly directed to the changing values. It is particularly true of railroad property. A board of assessors having once fixed the value is prone to consider that as very nearly final, and to increase it only at long intervals or as new lines are built or new equipment added. Unless there is some radical change in the law or in the administration, the valuation made in one year is the chief consideration in fixing the value the next year.

This tendency of a property tax to become stationary or to advance more and more tardily each year is strikingly illustrated in the history of California taxation.

(See section on Separation above.)

The Commission finds that the gross earnings tax in every one of the States where it has been long in use yields a steady and a very steadily

increasing revenue. The fluctuations from year to year are never serious and the general upward trend is much more rapid than the increase of the taxes levied on railroads under the *ad valorem* tax in other States.

The following table shows how a gross earnings tax in California would have compared with the taxes actually paid:

	Old System. For Every $100 Paid in 1896 the Roads Paid in Other Years.	Gross Earnings. For Every $100 of Taxes in 1896 the Roads Would Have Paid in Other Years.
1896	$100.0	$100.0
1897	83.3	95.3
1898	97.2	104.0
1899	91.9	118.0
1900	108.4	120.0
1901	107.3	140.0
1902	113.3	160.0
1903	142.9	176.0
1904	173.0	198.0
1905	167.0	205.0
Growth in 10 years	67%	105%

These figures speak for themselves, both as to steadiness and growth.

The Commission has collected a large amount of statistical data bearing on the question of the equity of a gross earnings tax as between the different roads, and as between railroad and other property. This material fully justifies the conclusion that it will be a great gain over the present system in both respects.

Conclusion.

Taxation, according to gross earnings, is simple and easy of administration. It is almost automatic in its operation, being the application of a mathematical rule, and not calling for the exercise of wide discretionary powers on the part of any officials. It is certain to yield a steadily increasing revenue. It adjusts itself to the ability of the company to pay, the tax being measured by the fund out of which it is paid.

No system of taxation has ever been devised, or can be devised, which would make allowance for every modifying circumstance. Taxation absolutely just and perfect is only a dream. Taxation on gross earnings as a method for taxing railroads comes as close to perfect equity as any system which can be devised.

The rate.

Of every $100 taken in as gross earnings from operation by railroads, from $34 to $39 are net; that is, are available to pay interest, dividends, or other capital charges. The normal percentage of net to gross in California is about 36%. If 1%, or $1.00 per $100 of full cash value,

is a fair rate of taxation on property in general, then a tax at 4% on gross earnings—the highest rate of the gross earnings tax in other States—assumes that railroad earnings should be capitalized at 9%. If we decide that railroads should be capitalized at 8%, then a gross earnings tax rate of 4½% would be the equivalent of 1% on property. Assuming that 7% is the proper rate of capitalization, the gross earnings tax ought to be a trifle over 5%. At 6% as the rate of capitalization the gross earnings tax rate should be 6%.

The United States census office, in an elaborate attempt to determine the commercial value of railroads, ascertained that in 1904 the Southern Pacific Company was, according to the market quotations of its stocks and bonds, actually capitalized at 5.655%; the Santa Fe at 5.172%. To these rates, which are net, less taxes, we have to add about 1% for taxes, making the market's opinion as to the proper return on these companies' investments, plus the taxes: For the Southern Pacific 6.6%, for the Santa Fe 6.2%. At 6.6% as the rate of capitalization the tax rate on gross earnings should be 5½%.

The Commission is of the opinion that the rate on gross earnings of railroads should not be less than 4% nor over 6%.

SECTION VII.

TAXATION OF PUBLIC SERVICE CORPORATIONS OTHER THAN RAILROADS.

On account of their size and of the importance of the revenues that they are able to pay, the steam railroads have been almost universally selected as subjects of State taxation in those States in which separation has been carried out. It is probable also that the extreme difficulty, not to say practical impossibility, of taxing steam railroads equitably in any other way than through some central administration forcibly suggested the desirability of State taxation.

Among the other corporations most frequently selected for State taxation are: First, and foremost, the banks and insurance companies. The banks because they can be taxed in no other way than as prescribed by the Federal law, which practically compels central administration, and the insurance companies because they rarely have any considerable amount of taxable property within the territory of any State.

The next set of corporations frequently selected for State taxation, as distinct from local taxation, are those engaged in transportation in connection with the railroads, such as the car companies, including sleeping car, refrigerator car, fruit car, oil car, and analagous car companies, and the express companies. Next to these, again, come the telegraph companies, whose business is so clearly non-local in character, and whose tangible property is so small in amount compared with the business done, that on either score they would be naturally selected for central taxation. The telephone companies are so closely analagous to the telegraph companies that if the latter are selected the former must be also.

The recent developments in the application of electricity to transportation have placed the street car companies in almost the same category as the steam railroads, and in a great many States the street car companies are included in the scheme of State taxation because so closely analagous to the steam railroads. Even when the street railroads are confined to a single city, they present on the whole a problem in taxation which cannot be successfully solved by the local administration alone.

There remain only two other classes of *great* public service corporations which naturally suggest themselves in this connection. These are

the light, heat, and power companies, and the water companies. Since the recent development of long distance transmission of electricity and the applicability of locally generated power to scattered industries, the light, heat, and power companies have taken on the essential characteristics of a general as distinct from a local industry. In California, in particular, where the long distance transmission of electric power has been developed on so large a scale, light, heat, and power companies fall distinctly among those which have a general, rather than a local, habitat.

The water companies present a peculiar problem by themselves. In the first place it seems to be the general tendency in America, a tendency which is less pronounced in California than elsewhere, for municipalities to own and operate their own water supplies. So far as this is the case in California it would be obviously unfair to those cities which do not own their own supply to select the water companies for State taxation, for it would grant the consumers in those cities which own their own water supply a practical exemption from a tax which other cities would have to pay. In the second place water rates are universally fixed by municipal ordinance, and in fixing them the authorities are compelled by the courts to take into consideration all the expenses, including taxes, incurred by the companies in furnishing the supply. Consequently the taxes are obviously shifted to the local consumers. This makes it appear as though the tax on water companies belonged peculiarly to the localities which they supply. In the third place, the Commission has ascertained that water companies are, for the most part, subject to fairly adequate taxes, and in some conspicuous cases are apparently overtaxed as compared with other property. The justification for this overtaxation is probably found in the fact that the burden is so readily transferred to the consumers. But aside from these three obvious objections to the assumption by the State of the right to tax water companies in lieu of local taxation, there is the further complicating circumstances in California in that the domestic supply of water in cities is often conducted in connection with local irrigation plants. It is felt that it is the spirit of the times in California to foster, and one might almost say to pamper, the development of irrigation in every way, shape, and form, and if the cities or counties desire to do this by tacit partial exemption from taxation, they should be permitted to do so. So far as irrigation itself is concerned, it is felt that this is an activity peculiarly local in character, and one which attaches itself in a subtle, yet distinct, way to the value of land, and so inseparable from the land values that it can scarcely be regarded, at present, at least, as having any other than a local character.

For all of these reasons the Commission has felt that it would be impracticable to include water companies in the general scheme of

central or State taxation. We have remaining, therefore, in addition to the steam railroads, banks, and insurance companies as subjects of State taxation, the *street railroads,* the *car companies* and similar transportation companies, the *express companies, telegraph* and *telephone companies* and the *light, heat,* and *power companies,* and in addition thereto, of course, the general franchises of all other classes of corporations.

Street car companies.

The Commission did not attempt to separate, in its investigations, those street car companies which operate within the confines of a single municipality from those which operate between several municipalities. The only line of distinction between the different classes of railroad corporations which it was found feasible to draw was the distinction made by the Constitution between railroads operated in more than one county and railroads operated solely within the county. We have, therefore, thrown together all the *intra*-county railroads, whether operated by steam, or electricity, horse, or other power. These *intra*-county railroads, according to the returns of the assessors, were valued by the assessors in 1905 at $44,226,079, and paid a total tax of $869,066.24, which is at the average rate of $1.965 per $100 of assessed valuation. The Commission has not yet fully completed its returns from these companies themselves, but those companies which have made returns show the following facts:

Gross income	$8,368,987.59	% Net to gross	45.55
Net income	3,816,518.48	% Tax to net	10.14
Total taxes	387,061.12	% Tax to gross	4.624

The most important item in these returns is the percentage of net to gross income, which, as shown above, is 45½%. The United States census office has published a separate report on street railroads alone for 1902, from which we take the following items for California:

The gross income of 35 companies was $9,967,288.
The net income of 35 companies was $4,565,043, or 45.8%.

It will be seen, therefore, that the percentage of net income to gross income obtained by the Commission corresponds very closely to that obtained by the census office. This percentage of net income is somewhat higher than the general average for the whole United States, which is 42½%.

Assuming that the fair rate of taxation on property is 1% of the market value, and assuming that investors in street railroad securities are entitled to a return of 6% upon their investment, a fair tax rate upon street railroads would be about 8% of the gross earnings. If we assume that the earnings should be capitalized at 7% the tax rate on

gross earnings would be 6⅔%. At 8% as the basis of capitalization the tax would be a trifle under 6%. The taxes now paid, which are about 5%, assume a capitalization of earnings at about 9¼%.

It is the opinion of the Commission that the tax on the gross earnings of all railroads, other than steam inter-county railroads, should not be less than 6% nor more than 8%.

The general laws of California require that after five years of operation street railroads shall pay 2% of the gross earnings to the local government which granted them their franchises. The San Francisco charter imposes still higher rates and eventual forfeiture of rights to the city. These charges were imposed at a comparatively recent date—1903--1905—and do not apply to franchises granted before that time. They are, moreover, of the nature of a rental, or a consideration for the grant of the franchises, an annual payment in place of a single cash payment, and they are in no proper sense taxes. They should, therefore, be excluded from consideration in connection with the proposed rates.

Car companies and freight companies.

The Pullman car, the refrigerator car, and similar car and transportation companies present a very peculiar problem. The contracts under which they operate in connection with railroads are such that the true nature of their earnings is not often clearly revealed. All car companies entering California, for which we have returns, are assessed at $981,485, and pay taxes to the amount of $18,831.17, the average tax rate being $1.998 per $100. We find that these companies are taxed at very varying rates in other States, but that in most cases they are treated precisely the same as railroads. The only exception is Vermont, which levies upon them a tax at the rate of 5% on their gross earnings, a rate far higher than is applied to railroad companies.

The Commission is of the opinion that these companies should be treated substantially as are the steam railroads.

Express companies.

There is no class of corporations in regard to which the propriety of a central administration of taxation is more obvious than that of express companies. Their business permeates all parts of the State, and involves the use of a comparatively small amount of tangible property. Their earning power is based mainly upon the contracts which they have with the railroad companies, and upon their organization of agents, etc., for the collection and distribution of goods. After very careful investigation the Commission is satisfied that these companies earn on the average about 15% net; that is, 15% of their entire receipts are

net. On the basis already used a fair rate on the gross earnings of these companies would be about 2½%. This rate is, however, lower than in some other States, which levy a gross earnings tax. In Connecticut the rate is 5% and in Delaware 5%. These higher rates are presumably based upon a different condition as to earnings from that which exists in California. The only reason for applying a higher rate than 2½% would be one based upon the assumption that the express companies, owing to their close relation to the railroad companies, are paying a comparatively high rate for the transportation of their freight. At 2½% tax on gross earnings would increase the taxes paid by these companies from about $16,000 to nearly $75,000.

Telegraph and telephone companies.

We are fortunate in having an excellent and complete set of returns in regard to telegraph and telephone companies, published by the United States Census Office. The following tables show the essential items taken from these reports.

TABLE I.

All Telephone Systems, Commercial and Mutual, 1902.

	California.	United States.
Gross receipts	$3,993,698 00	$81,599,769 00
Operating expenses	3,199,574 00	56,867,062 00
Net income	$794,124 00	$24,732,707 00
Taxes	82,807 00	2,944,281 00
Net to gross	19.87%	30.31%
Tax to gross	2.073	3.609

TABLE II.

All Commercial Telephone Companies (Exclusive of Mutual).

Gross receipts	$3,990,040 00	$81,296,444 00
Operating expenses	3,196,595 00	56,591,746 00
Net income	$793,445 00	$24,704,698 00
Taxes	82,803 00	2,940,430 00
Net to gross	19.89%	30.39%
Tax to Gross	2.075	3.617

TABLE III.

Telegraph Companies, United States at Large. Commercial System Only.

	United States.
Gross receipts	$35,300,569 00
Operation and maintenance	26,592,411 00
Net income	$8,708,158 00
Taxes	588,726 00
Net to gross	24.7%
Tax to gross	1.668

We have reports from six commercial companies in California—telephone and telegraph—which show the following data (exclusive of the Western Union).

TABLE IV.

Telephone and Telegraph, 1905.

Gross	\$4,284,920 15
Net	760,966 65
Tax	131,074 17
Net to gross	17.74%
Tax to gross	3.06

It would seem from the above that 4% would be a fair average rate on the earnings of telegraph and telephone companies. This assumes a rate of capitalization at 5%. The par value of the capital stock and bonds of all telephone companies in the United States is \$348,000,000. The net earnings before payment of taxes are 7.1% thereof.

Light, heat and power companies.

The light, heat and power companies of California are assessed for \$20,775,736, and pay a total tax of \$424,487.64, which is at the average rate of \$2.043 per \$100. The earnings of those companies for which we have returns have been tabulated as follows:

Gross income	\$9,136,372.30	% Net to gross	30.96
Net income	2,828,463.91	% Tax to net	9.78
Total taxes	276,708.31	% Tax to gross	3.03

By the same method of computation which we have used before we find that if the property of this class of corporations is capitalized at 6%, its tax would be 5% on the gross earnings. From data furnished by the United States Census Office in one of its published bulletins we find, however, that central light and power stations earn 39% net out of all their gross receipts, which at a 6% rate of capitalization implies a tax rate of 6½% on the gross earnings. The Commission is, therefore, of the opinion that the rate for these companies should be not less than 5% nor more than 6½%.

The following table presents a summary of the Commission's conclusions regarding tax rates to be applied upon the gross earnings of public service corporations, other than steam railroads, and exclusive, of course, of banks and insurance companies:

	Minimum.	Maximum.
Street railroads	6%	8%
Car companies	4%	6%
Express companies	2½%	5%
Telegraph and Telephone	4%	4%
Light, heat and power	5%	6½%

After further investigation the Commission hopes to be able to make more definite recommendations as to the rates to be applied to each class of corporations. The rates are matters which can be determined with almost mathematical accuracy. They should not be fixed by *guesswork, sentiment, or prejudice.*

SECTION VIII.

TAXATION OF BANKS.

Taxation of banks under the present system.

The existing system of taxation breaks down completely when applied to the taxation of banks.

It has been held by the Federal courts that the provisions of the California statutes in regard to the taxation of national banks are in conflict with the provisions of the Federal statutes. Hence, the national banks pay no taxes at all in California, except on their real estate. This is bad. It is unjust to the State banks, and unjust to the people of the State.

The provisions of our revenue law in regard to the taxation of State banks are so difficult to apply, and would, in many cases, work so much hardship if applied as it was originally intended they should be applied that they are largely evaded. The result is that these banks are taxed without uniformity, equality, or regularity.

The reports made to this Commisison by the banks throughout the State show that the assessors are practically powerless, under the present system, to make a fair and equitable assessment of the banks. This failure of the tax-system has come about without any particular breach of the law, and without any special blame attaching to the banks or to the officials in charge of the administration of the law. The trouble arises from the inadequacy of the present system of taxation.

The banks may, by processes that are perfectly "legal" and which can not even be called improper, so manipulate their investments as to hold no property taxable under the present law. If this manipulation is not accomplished just before tax day with the obvious intent to evade taxation there is no way in which the assessor can call a bank to account therefor. In fact, the banks are practically compelled by the present system of taxation to so handle their investments as to evade taxation, and they are often forced to do this to the detriment of their business. No bank can well afford to hold a taxable note, stock, or bond yielding four or five per cent interest if two out of the four or five per cent is liable to be taken for taxes.

The reports made to the Commission show, furthermore, that there is the greatest diversity in the application of the law in the different counties of the State. The resulting lack of uniformity is appalling. This arises from the fact that the application of the tax law to the banks is an extremely complicated matter. To ascertain the proper assessment of a bank requires a long and intricate computation and an intimate knowledge of the peculiarities of the banking business,

which the average assessor can not be expected to have. In fact, it often defies the acumen of the keenest and most experienced officers in the service.

The situation grows steadily worse each year, as a result of the increase in the number of banks, the ever-increasing competition between the banks and the ever-increasing complexity of modern business relations and business methods. It is worse since 1905 than ever before, on account of the decision of the Federal courts, which has exempted national banks from the operation of our tax system. The taxed State banks have to compete with the untaxed national banks, and they find the taxes a very severe handicap. Naturally they avail themselves of every possible expedient to get rid of this handicap and to place themselves on an even footing with their competitors.

A tax law applicable to only about half of the class of taxables which it is intended to cover, and so full of loopholes that its operation is always uncertain and inequitable, calls urgently for immediate reform.

Under our revenue law all banks, except savings banks, are taxable in precisely the same manner as are individual citizens.

The proposition of the lawmakers who devised this system was that the banks should be required to pay taxes on all the property they own, or hold, clear of incumbrance, in the same manner as a farmer, a merchant, or any other property owner. If banks could be so taxed there would be no ground for complaint. But this naive theory breaks down completely in practice. Provisions of the law that are proper enough in their original conception and when applied to individuals work grievously askew when applied to banks.

The final report will contain a careful examination of the different kinds of property held by banks and of the provisions in regard to their taxation which will show wherein the law breaks down.

Taxation of savings banks.

Savings banks are discriminated against by our revenue laws. Their taxes are more than half again as heavy as those paid by State commercial banks, and five times as heavy as those paid by national banks. This is the direct opposite of the policy of most other States, which undertake, in general, to favor the savings banks as a means of inculcating thrift among the people.

This discrimination came into existence from a provision intended to favor the depositors in savings banks, which failed of its purpose, because it failed to take into consideration the impossibility of enforcing the provisions of the law in regard to commercial deposits. Commercial banks may deduct their debts, among which are the deposits, from all their taxable credits. This is allowed because the deposits are taxable to the depositors. But the depositors evade taxation. In the

case of savings banks, however, the law provides: "But credits, claims, debts, and demands due, owing or accruing for or on account of money deposited with savings to loan corporations, shall for the purpose of taxation be deemed and treated as an interest in the property of such corporation, and shall not be assessed to the creditor or owner thereof." (Pol. Code 3617, § 6.) Savings banks are, therefore, taxable on the entire amount of their solvent credits without allowance for deposits. Hence the burden of taxation on savings banks, while not abnormally high, is materially higher than on commercial banks. Savings are not overtaxed, but commercial banks are undertaxed.

That provision of the law which makes the bonds of foreign corporations taxable, also works an exceptional hardship on savings banks, which are confined in their investments to mortgages, and to the non-taxable bonds of California municipalities or of California corporations. This not only restricts their field of investment, to the detriment of their earnings, but is an actual source of danger in times of special stress, inasmuch as the market for these bonds, should the banks be forced to sell them, is restricted.

Taxation of national banks.

The United States Supreme Court has decided that the State may not tax national banks under our existing laws. This was decided in the case of San Francisco National Bank vs. Dodge, 25 Sup. Ct. Rep. 384, p. 18. The final report will discuss this decision at some length.

How national banks may be taxed.

The Commission has made a careful examination of all the decisions of the courts relating to the taxation of national banks.

In general, the power of the States to tax national banks rests solely upon the permission of Congress. Congress has provided the method in which this power may be exercised, and no other method is legal.

U. S. Revised Statutes, Sec. 5219: "Nothing herein shall prevent all the shares in any association from being included in the valuation of the personal property of the owner or holder of such shares, in assessing taxes imposed by the authority of the State in which the association is located; but the Legislature of each State may determine and direct the manner and place of taxing all shares of national banking associations located within the State, subject only to the two restrictions, that the taxation shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such State, and that the shares of any national banking association owned by non-residents of any State shall be taxed in the city or town where the bank is located, and not elsewhere. Nothing herein shall be construed to exempt the real property of associations from either State, county, or municipal taxes to the same extent, according to its value as other real property is taxed."

The conclusions may be summarized as follows:

States may tax the shares of capital stock in national banks as property of the shareholders, at the same rate and valued in the same

way as other banking capital. In no other way may they tax either the bank or the shares of stock or the stockholders.

The decision means, substantially, that the States must tax all banks alike or forfeit the right to tax national banks at all.

Present burden of taxation on banks.

The taxes paid by all the banks in California amounted in 1905 to $721,426.67, which was less than 6-10 of 1% on their capital, including in the capital the accumulated surplus and undivided profits. Those paid by State commercial banks amounted to $383,732.75, or less than 8-10 of 1% on their capital. Those paid by the savings banks amounted to $263,984.91, or about 1¼% on their capital. The national banks paid only $73,709.01, or a little over 2-10 of 1% on their capital. These amounts are exclusive of the taxes on mortgages, which although advanced by the banks are not borne by them, being invariably shifted to the mortgagor. They include only taxes paid and borne by the banks.

The burden of these taxes falls on the stockholders of the banks, whose dividends are lessened thereby. Their payment, even in the case of savings banks, does not affect the rate of interest paid on loans or deposits, that being fixed entirely by competition.

These taxes are too low, considering the nature of bank capital and its earnings. They are lower than those on other property taxed, or on investments of a like character. Bank stock, generally speaking, stands high as an investment. It is regarded as safe and respectable, and is usually remunerative. It is readily salable, and usually commands a high premium. The capital invested in banking is money, and so long as the bank is solvent is worth dollar for dollar. The shares which represent the capital are in most cases worth more than their "book value."* The book value of the stock of the Bank of California is reported by the Bank Commissioners as $334; its market value is about $425, according to the last quotations. The book value of the stock of a certain interior savings bank was $65.80; the market value, it was claimed, was $500, but as sales do not often take place the market value is rather indeterminate. In another case, the stock of a national bank in one of the bay cities outside of San Francisco had a book value of about $175 and was firmly held at $300. Just exactly what the market value of a share of stock in a given bank may be is not always easy to determine. Except in the case of a very few banks in large centers, the stock is not quoted "on exchange." Usually bank stock is closely held, and outsiders are "let in" more or less as a personal favor or to

*The "book value" of a share of bank stock is determined by adding together the amount paid in per share and its *pro rata* of the amount of the accumulated surplus and undivided profits. It is the amount which in case of voluntary liquidation *would be paid* the shareholders for each share.

strengthen the bank by adding to its prestige or to reach a new clientage. Sales are rare and are not often given publicity. But it is indisputable that except in the case of new banks or of notoriously weak ones, the market value of the stock is above the "book value."

The earnings of bank stock in California are high. The following table has been compiled from the reports of the Controller of Currency, and shows the earnings of national banks in several States. It will serve the double purpose of showing the lucrative character of bank stock as an investment and of affording a comparison between the burden of taxation on banks in California and in other States, with whose system of taxation we wish later to make comparison.

Comparative Statement of the Percentages of Semi-Annual Net Earnings to Capital and Surplus of National Banks in Certain States.

(Computed from the Reports of the Controller.)

Year.	California.	Connecticut.	New York.	Pennsylvania.	Wisconsin.	New York City.
1900	4.84 6.15	3.42 3.26	5.47 8.38	4.87 5.37	5.24 6.35	6.37 10.32
1901	5.20 5.19	3.34 3.04	4.31 5.03	4.55 4.41	5.42 5.58	4.57 5.95
1902	6.06 5.48	3.10 3.04	11.32 5.27	4.44 4.78	6.38 5.30	14.40 5.61
1903	6.61 5.57	3.36 3.10	5.68 5.69	5.15 4.69	5.53 5.51	5.97 6.26
1904	6.18 5.17	3.16 2.80	7.86 4.48	4.30 4.33	5.98 5.31	9.04 4.64
1905	5.47 4.72	2.41 3.06	4.14 4.44	4.43 4.16	5.05 4.87	4.05 4.49

Comparative Statement of the Three-Yearly and Six-Yearly Averages of the Percentages of Semi-Annual Net Earnings to Capital and Surplus of National Banks in Certain States.

	1900-1-2.	1903-4-5.	1900-5.
California	5.48	5.62	5.543
Connecticut	3.20	2.98	3.09
New York	6.63	5.38	6.005
Pennsylvania	4.73	4.51	4.62
Wisconsin	5.71	5.37	5.54

It will be noted that the average net earnings of national banks in California are over 11% per annum, on all that the stockholder has invested; that this rate is exceeded by New York only, all other States in the list being lower. The high average rate in New York is, however, somewhat anomalous, being caused by the extraordinarily high earnings of banks in New York City in the second half of 1900 and in the first half each of 1902 and 1904. Eliminating these, which are obviously exceptional—14% semi-annually, or at the rate of 28.8%

N. B.—Double these percentages will give the *annual* net earnings.

per annum may be called very remarkable—California would be above the average even for New York City. The country banks in New York earned an average of 4.056% semi-annually during the six years; banks in Brooklyn 4.009%, in Albany 3.705%.

It follows from this showing that bank stocks in California constitute a lucrative investment. Incidentally, it may be pointed out that California banks can well afford to pay at least as high taxes as are paid by banks in other States. This will be considered in connection with the determination of the rate.

Taxation of banks in other States.

The methods used for the taxation of banks in other States are, in the main, those suggested or prescribed by the Federal statutes and the Federal courts for the taxation of national banks.

In every State in the Union, except California and Nevada, banks are taxed by laying a tax on the shares of bank stock assessed to the shareholders, or by a method substantially equivalent thereto. Only California and her nearest neighbor, Nevada, cling to the old-fashioned property tax as far as banks are concerned.

The plan proposed by this Commission for the taxation of banks.

The plan for the taxation of banks proposed by this Commission involves the following points:

1. All banks and all moneyed capital shall be taxed alike, *i. e.*, in the same manner and at the same rate.

This is necessary if the State is to tax national banks at all. The Federal government has virtually prescribed this, for it prohibits the taxation of national banks unless all others are taxed in the same manner and at the same rate.

2. The tax shall be a State tax, and the banks shall be exempt from all other taxes, except local taxes on real estate. (See 6 below.)

This is an essential part of the general scheme for the separation of State from local taxation, as outlined elsewhere.

But more than that, it is essential to any uniformity in the administration of the revenue law in regard to banks and to equality between the banks.

3. The tax shall be based upon the capital of the banks including accumulated surplus and undivided profits. The tax shall be assessed to the stockholders and paid on their behalf by the bank.

This provision keeps within the rules of the Federal government in regard to the taxation of national banks. No other plan is countenanced by the Supreme Court of the United States.

This provision, however, is eminently just. The capital of a bank, including its accumulated surplus and undivided profits is what the *stockholders own.* They do not own the deposits in any economic sense,

although in a strict legal sense the bank is the owner thereof until they are demanded and withdrawn by the depositors. In the same sense they do not own the investments made by the bank with moneys on deposit. What is theirs, indisputably, and would be given them in case of liquidation, is the paid up and unimpaired capital and accumulated surpluses or profits.

4. The shares of stock shall be assessed or valued at their "book value," or the amount paid in thereon plus the *pro rata* of the accumulated surplus and profits. (For deduction of real estate see 6 below.)

Unless the bank's capital has been impaired by losses, in which case it is the universally acknowledged duty of the stockholders to immediately make good the loss, or failing that to allow the bank to go into liquidation, the stock is worth at least its book value. That amount is there in cold cash or in investments readily changeable into cash. This is the minimum value of bank stock. No stockholder would sell his shares for less, any more than he would sell a twenty-dollar gold piece for less than $20.00.

The only other possible basis of valuation is the "market value." Bank stock, especially the stock of some of the stronger banks, sometimes sells for more than its "book value." The elements which enter into this excess of market value over book value are mainly of the nature of "good will," or arise therefrom. This excess depends primarily on the bank's ability to earn rich dividends and to lay aside profits to add to the capital. A bank's ability to do this depends in turn largely upon the character, ability, and reputation of its directors and stockholders, its past history, dignity, and standing; in short, on its good name.

The attempt, under an interpretation of our present law, to tax this as a "franchise" is absurd. It assumes that the State has bestowed on the bank what its incorporators have really created themselves.

This Commission decided against recommending that the assessment be on market value and chose book value instead for the following reasons:

First—To use market value would be to introduce an element of uncertainty, of personal judgment into the assessment. The book value is a positive thing. There is no doubt about its amount. The market value fluctuates. In the case of some banks whose stocks are frequently quoted on the stock exchange the market value is well known. In the case of others, whose shares seldom change hands, it is not so well known, and may be difficult to determine. In most cases the market value of bank stock is a matter on which opinions differ. It is desirable, if possible, to base the tax on some element which facilitates the use of a mathematical rule without dependence on anybody's judgment.

Second—It is not customary to tax the "good will" of mercantile or manufacturing concerns, and by using book values we should be

giving the banks a corresponding abatement, the excess value being akin to good will.

Third—The choice of book value, as against market value, is a matter which concerns primarily the equity between banks. It is an open question whether high market value to bank stock necessarily indicates proportionately high ability to pay taxes. At all events a uniform rate on book value seems to impose a uniform handicap on all banks. So far as the revenue is concerned it is a mere matter of rate. Whether we take a given percentage of the book value or a lower percentage of market value is merely a matter of mathematics; the result is the same, the revenue is the same.

Fourth—The increased cost of the central administration of the system, if market value were to be used, would very nearly offset any probable loss in revenue from the use of the book value.

The main thing is to secure a system at once simple, effective, uniform, and as nearly just as any system of taxation can be.

5. The rate shall be 1% on the book value of the shares, less real estate taxed locally.

This rate was arrived at in the following way: Banks are located in cities. The average city rate is $2.10. Property is assessed at 60% of its value; $2.10 on $60 is the same as $1.26 on $100. It would seem, then, that 1¼% would be a fair rate. But a committee of the bankers which appeared before the Commission, and urged that even 1% was a high rate. The grounds of their contention were that mercantile capital is valued at less than 60%. The Commission is of the opinion that real estate is the better basis of comparison, but that whatever merit there may be in this contention is conceded when reduction is made from 1¼% to 1%. It is also of the opinion that 1% is a low tax on a business that is making over 10% per annum clear of all expenses.

In further support of their objection to the rate, the committee of bankers urged that California banks could not afford to pay as high taxes as the banks in Eastern States, many of which do pay 1% and over in taxes. This contention led the Commission to investigate the earnings of banks here and in those States which do use a rate as high as that proposed. The table given above was the result. It was found that the earnings were higher in California than in those other States. All New York banks, whether the rich banks in New York City, or the comparatively poorer ones in the country, pay alike 1% on their capital and surplus *without* deduction for real estate taxed locally. This would be equivalent to a rate of $1.175 per $100 in California. The rates in the other States are:

Connecticut, 1% on the market value of stock.

Pennsylvania, 1% on the par value. (There are other options, but *that is the most* favorable.)

Wisconsin, State and local rates, whatever they may come to, reported to be about $1.60, on a valuation made by the assessor, which several banks claim is the full value.

It seems, then, that the committee of bankers was mistaken in its contention that California banks could not afford to pay as high taxes as their Eastern colleagues.

6. All real estate, including mortgages, belonging to the banks, shall be taxed locally as heretofore. But in fixing the value of the shares the banks shall be allowed to deduct from the book value of the shares the value, as assessed for county purposes, of any real estate, other than mortgage interests therein, upon which they pay local taxes.

This again is copied from the provisions of the Federal law. But its justice is so obvious that it requires no further argument.

As the banks merely advance the tax on the mortgages, recovering it in the shape of higher interest from the mortgagors, there is no reason for allowing them to deduct mortgages.

7. Private banks and bankers should be taxed in the same manner as other banks, on the capital employed by them in their business.

Table Showing the Assessed Valuation and Taxes Paid by Banks in California. Also the Amount of Taxes Imposed on Banks by the Plan of the Commission.

	Commercial.	Savings.	National.	Totals.
Number of banks included in this compilation	241	96	82	419
Assessed valuation on county rolls, 1905 (exclusive of mortgages)	$19,732,848 00	$13,070,179 00	$3,091,280 00	$35,894,307 00
Segregation of the above:				
Real estate	$6,935,379 00	$3,227,202 00	$2,530,345 00	$12,692,926 00
Cash	6,470,372 00	3,637,743 00	166,199 00	10,274,314 00
Solvent credits	4,254,351 00	4,059,390 00	49,338 00	8,363,079 00
Stocks and bonds	249,013 00	1,409,023 00	6,250 00	1,664,286 00
Franchises	1,492,321 00	543,257 00	3,060 00	2,038,638 00
Fixtures	302,532 00	180,849 00	213,016 00	696,397 00
Miscellaneous	28,880 00	12,715 00	123,072 00	164,667 00
Taxes paid 1905 (exclusive of taxes on mortgages)	$383,732 75	$263,984 91	$73,709 01	$721,426 67
Segregation of the above:				
State and county taxes	$181,470 07	$108,495 53	$33,398 99	$323,364 59
City taxes	188,775 66	143,116 68	38,299 18	370,191 52
Miscellaneous taxes	13,487 02	12,372 70	2,010 84	27,870 56
Amount of proposed State tax at 1% on capital and surplus, less assessed value of real estate	$481,214 08	$210,472 08	$336,427 62	$1,028,113 78
Amount of local taxes on real estate at assumed average of new local rates of 1½%	104,030 68	48,408 03	37,955 17	190,393 88
Total taxes under new plan	$585,244 76	$258,880 11	$374,382 79	$1,218,507 66
Per cent of new taxes to old	152.51	98.06	507.92	168.90
Taxes advanced by the banks on mortgages	$217,521 08	$1,555,875 08	$8,982 36	$1,782,378 52

SECTION IX.

TAXATION OF FRANCHISES.

There are three different classes of franchises belonging to corporations recognized by the revenue laws of California as taxable.

The first is the franchise to be a corporation, a privilege accorded to any three or more persons who associate together in the manner prescribed for the formation of private corporations. This franchise conveys the right to use the corporate name, to have a corporate seal, to sue and to be sued, and in general to enjoy the privileges ordinarily permitted to corporations. The charge imposed at the time of granting the articles of incorporation is a fee, which varies with the amount of the capital proposed for the company. The fees imposed in California for granting this kind of a franchise by the State are paid to the Secretary of State at the time the articles of incorporation are filed. Other States charge similar fees for incorporation.

The Commission is of the opinion that these fees should stand.

The second sort of a taxable franchise recognized by the laws of California corresponds to what is sometimes called the franchise "to do or to act;" that is, not merely the privilege of becoming a corporation, but the privilege of carrying on business and of continuing to be a corporation. This kind of a franchise is subject to an annual charge or fee paid to the State, which was imposed for the first time by the Legislature of 1905, and amended again by the special session of the Legislature in 1906. The fee was originally $10 from every corporation, domestic and foreign, doing business in California, and was raised to $20 covering the same class of corporations, and imposed in the same manner.

While this charge as it now stands on the statute books seems to be a charge primarily for revenue purposes, it was undoubtedly originally conceived as a fee for a special service; namely, the service of keeping a continuous record of existing corporations and of weeding out and wiping off the records of the State all corporations which were not continuing in business. In the framing of the law the latter purpose seems to have been partially lost sight of, inasmuch as no provision was made for calling for a report as to the standing of the company, its business, outstanding capital, bonded indebtedness, and the like, which is usually connected with the imposition of similar charges in other

States. Such annual franchise fees are found in some other States, but not many.

The rates charged are very complex, and are usually graduated or proportional. A flat rate like ours is very unusual.

The Commission recommends a proportional tax at 1-10 of 1% of the capital.

Third, the revenue laws, as interpreted by the courts, recognize two other kinds of franchises, which we may call for convenience special and general, so closely analagous as to be difficult to distinguish one from another, which are subject to taxation as property, and are included in the assessment of the property of the corporations. One of these requires a special grant, the other is acquired under the enjoyment of the powers conferred by the general law for incorporation, and is, as will be explained below, akin to "good will." These two classes of franchises are here grouped together and treated as one class, simply because they are valued for purposes of taxation in practically the same manner.

The first to be recognized in California as a franchise, taxable as property, were the special franchises enjoyed by public service corporations, such as water companies, gas companies, street railway companies, and the like, which use the public streets under some special permission or enjoy some special privileges not ordinarily granted to citizens generally. This sort of a special franchise has been taxable in California for a long time. They were taxable under the old Constitution, and the new Constitution singles them out as a special subject for taxation. There is no necessity to review the large number of cases decided by the Supreme Court of the State dealing with the taxation of this class of franchises, because there is no dispute as to the fact that they are property and are taxable as such. The United States Supreme Court, as well as the California Supreme Court, has uniformly sustained the taxation of this class of property.

From this the practice has grown up, and is sanctioned by the courts, of assuming that every corporation, whether a public service corporation or not, has some sort of a franchise which is taxable, in the same manner as those mentioned above.

Special franchises are taxed in most other States in one way or another. In States where the corporations are covered by general or special corporation taxes, those taxes are so designed as to include the value of the special franchises. When the corporations are covered by the general property tax, the value of these franchises is included, either as a special item in the assessment or in some other manner. In New York, such a special franchise is defined as the right to use the public streets, to go beneath them or to go above them. They are valued by the State Tax Commissioners, but subject to local taxation

in the town where they are located. In other States they are covered by an assessment levied on what is known as the "corporate excess." This is the case in Illinois. The "corporate excess" may be defined generally as the amount by which the value of the outstanding securities, as indicated by their market value or by their annual earnings, dividends and surplus, exceeds the value of such tangible and visible property as can be found.

The general method approved by the courts of California, and originally prescribed by the Code for the determination of the value of these special franchises, rests upon the same idea as that underlying the determination of the corporate excess described above. To determine the value of these franchises the assessor is supposed to ascertain the total value of all the outstanding securities, and to deduct from that the value of any visible or tangible property which he may find in the possession of the corporation, and the difference is then assessed as the value of the franchise.

As will be explained at some length in the chapter of the final report relating to the taxation of banks, the Supreme Court of California has held that the same method may legally be used for the determination of the value of the franchise possessed by any corporation, whether a public service corporation or not.

As our law goes on to provide that the franchise of any corporation shall be assessed at the place where the head office is located, it appears that the Code, at least, contemplated the assessment of the franchises as property against every kind of corporation. It may well be that the Constitution makers had no such intention when they defined franchises among those articles of property which should be taxable, for in the course of the discussion in the Constitutional convention, the question was distinctly asked as to whether the franchises of mining corporations would be taxable at the place of the head office, or in the place where the mine was located, and the advocates of this part of the Constitution replied emphatically that a mining corporation had no franchise of any value apart from its tangible property. Nevertheless, the practice of assessing even mining companies for their franchises at the place where the head office is located, whether that be where the mine is located or not, has grown up out of the provisions of the Code, and such practice is sustained by the courts. In a more recent decision the courts have held that all special franchises, such as the right to use the public streets, must be taxed where the franchise is located, or where it was granted, and that this class of franchise is not included under the general franchise, which is to be taxed at the place where the head office is located.

While these two classes of franchises, which for convenience we have called the special and the general, are, in the opinion of the Supreme

Court, apparently almost precisely alike, and are to be treated in the same manner for the purpose of taxation, they are from the economic point of view fundamentally different.

The franchise of a bank in this sense is closely analagous to that kind of property known as "good will." This is a class of property which presumably might be taxed under the provisions of our revenue law, but which, as a rule, is never taxed except in those cases in which it is enjoyed by corporations, and then it is taxed as a franchise. It is a question open for serious consideration whether the taxation of such a franchise, tantamount to the taxation of the good will, against corporations, while similar items of property, if this be property, are not assessed against individuals and firms does not constitute an unjust discrimination against corporations.

The taxation of franchises of this class is a much vexed question in California at the present time. Corporations generally protest loudly that it forms an unjust discrimination against them, and the assessors are, for the most part, doggedly determined to put such property on the assessment rolls in accordance with a strict interpretation of the law and the Constitution, which has been made by the Supreme Court. The friction at this point is intense, and the feud between the corporations and the assessors over it is growing more bitter every year. The assessors see, or think they see in it, a means of making the corporations contribute what the assessors hold to be the corporations' due share of the taxes; while the corporations see in the exercise of this power on the part of the assessor the possession of an entirely arbitrary power, not subject to any restraint or control. "If," said a prominent corporation attorney, "the assessor may value the franchise of the Bank of California at $750,000, and of the Fireman's Fund Insurance at $50,000, and if the courts refuse to review, as they have done, the assessor's exercise of his discretionary powers in this respect, what is to hinder him from making these assessments four or five millions respectively?" The right of the corporation aggrieved to appeal to the Supervisors sitting as County Board of Equalization does not seem to the corporations to furnish them sufficient protection against an arbitrary exercise of this power.

The whole matter of the taxation of franchises is in an extremely unsatisfactory condition. Any solution of the problem will be extremely welcome to both sides of the controversy. There is no doubt whatever that there is an element in the value of corporate property which is over and above the value of the tangible and physical property. It is a value which attaches to all the property of the corporations because of its income or earning power. If, however, the corporations are taxed upon the basis of their earnings, the vexed question disappears. It does not exist in Europe, because corporations there, like individuals,

are taxed upon the basis of their earnings. The plan proposed by this Commission for the solution of this vexed question is, first, to place the entire matter of the taxation of franchises, other than the special local franchises, in the hands of the State, and subject them to an annual franchise tax in proportion to the capital used, and to let that suffice for what may be called the general franchises; then to cover special franchises of public service corporations in general by a corporation tax based upon some other principle than the assessment of the property by the local assessor. It is thought that this method will reach equitably all of the different classes of franchises involved.

There is undoubtedly a strong demand in this country, which has found expression in California, for the taxation of franchises. The causes for this demand have been enumerated by Mr. Judson in his work of Taxation in Missouri, as follows: "This springs, not only from the sense of justice which requires that the public burdens should be shared by all in proportion to their ability, and that all of the wealth protected by the State should assist in the support of the State, but it is doubtless intensified by the popular discontent with the confessed failure of our present taxing system to reach the wealth invested in public and private securities.

"Another cause has doubtless operated to intensify the popular demand for the taxation of the franchise, and that is the public realization of the recklessness and jobbery which has attended the granting of franchises for the use of streets in our municipalities. Although the city charter of St. Louis, as well as the statutory charters for the different classes of cities, authorize the application of the rule of public competition in the granting of franchises, this authorization has been all but universally ignored, and private favor instead of public competition has been the rule. The result is that our cities find themselves, in their financial straits, deprived of the means of revenue which they might have secured by exacting conditions for the granting of these franchises when they were in eager demand. While cities have the right to impose conditions in the granting of such franchises for the use of their streets, when once granted and vested rights are based thereon, such vested rights can not be divested without compensation. Such vested rights are subject, however, as other property, to the taxing power of the State."

He might have added another cause which intensifies the demand for the taxation of franchises; namely, the feeling that the granting of the franchises makes private property out of what, in the nature of things, is public property, and that while, for the convenience of the operation of public utilities, it may be best to leave them in private hands, yet private corporations are in such instances using public property. This feeling, which undoubtedly underlies the strong demand

for the separate taxation of franchises, rests upon a serious confusion of thought. There is a decided distinction between a charge made by a municipality for the use of its streets by a public service corporation and a tax proper. The one is rent for the use of public property, the other is an assessed contribution for the support of government and the furtherance of the general aims of society. If, through improvidence or corrupt granting of municipal franchises the municipality has temporarily alienated its birthright, it can not expect to undertake to make good again by excessive taxation.

Mr. Judson expresses this idea as follows: "But when we fail to avail ourselves of such opportunities, and public opinion permits our streets to be occupied by poles, rails, pipes and conduits, for the asking, under railroad, gas, electric, water, and other franchises, and vested private rights are created thereon, these are rightfully subject to taxation* as other property, but, as other property, are protected during the term of such franchises against confiscation or spoliation."

The system of taxation imposed to cover franchises should be one equitable in itself; the power to tax should not be used as a means of redressing wrongs, real or fancied, the result of lack of foresight in the past.

*In Connecticut, shares in foreign companies are taxable unless the shares, or what they represent, are taxed in the foreign State to the same extent as other like property owned by citizens. In the latter case they are not taxable in Connecticut. The courts have held that such stock *prima facie* is deemed to be taxed in the foreign State so that the assessor, in order to tax it, must prove that it is not taxed elsewhere; and the result is that such shares are practically exempt.